Multifamily housing: will you seize the first mover advantage?

The better the question. The better the answer.
The better the world works.

Building a better working world

Introduction

Attitudes towards home ownership in Australia are changing.

According to the most recent national census, nearly one third of Australians (30.9%) now rent.[1]

And this figure is on the rise, as Millennials and Generation Z – who make up 48% of our population – choose lifestyle and location over home ownership.

At the same time, Australia's private rental market – which has historically supplied most of our nation's private rental accommodation – is changing due to increased pressure on negative gearing.

Recent government interventions to address housing affordability, coupled with uncertainty around future taxation policies, are disrupting investor activity.

The question is clear: who will supply the stock for Australia's private rental market in the future?

Multifamily housing – a sub-sector of the emerging build-to-rent asset class – has the potential to stimulate large-scale new residential property supply, moderate Australia's housing affordability crisis, while providing alternate opportunities for residential developers and stable long-term income for institutional investors. If managed correctly, multifamily housing will encourage institutional investors to enter the Australian housing sector to fill the gap left by retail/individual investors.

The time is right for the market to move on multifamily housing.

New kids on the block

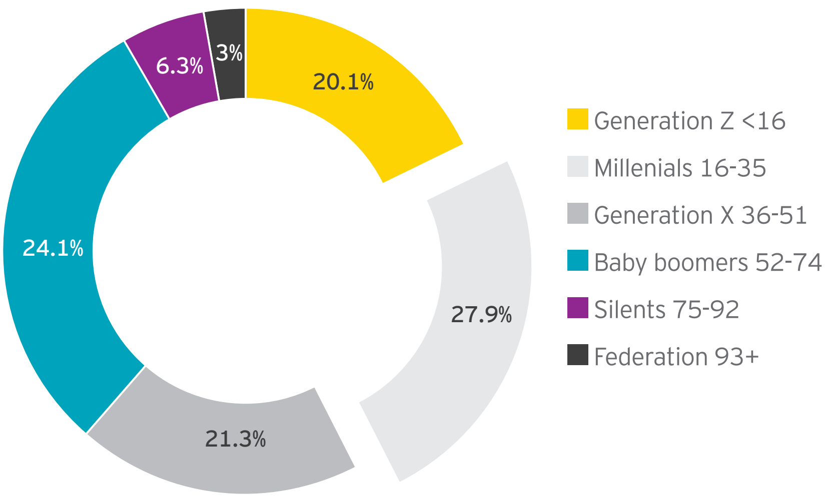
Born between 1982 and 2009, Australia's 11.76 million Millennials and Generation Z are reshaping attitudes to housing.[2]

These Australians are tech-savvy, globally and digitally connected, more formally educated and more mobile than any generation before them. This mobility – when it comes to jobs, careers, cities and even countries – means they are more likely to prioritise lifestyle and location over home ownership.

Fully-fledged members of the sharing economy, these Australians understand why borrowing a bike or ballgown makes sense, and so are prepared to trade off personal space for communal amenity that brings people together on their own terms.

These trends point to the potential for a rental product where people are the priority and high levels of service are the standard.

GRAPH 1: **Australia's generational composition**



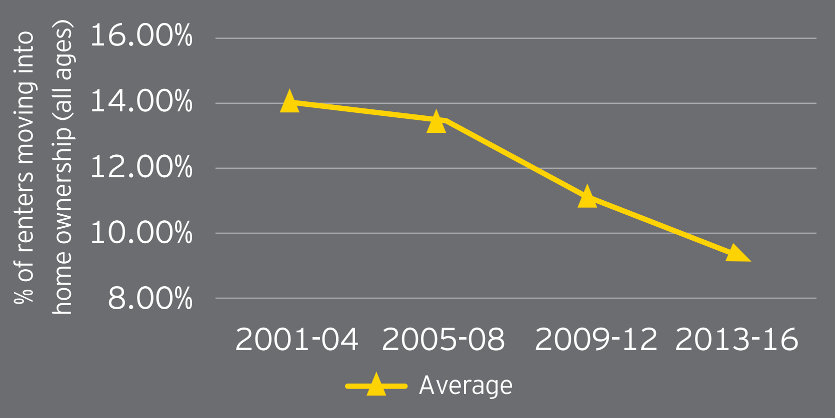
Source: IBIS World, The Millennials are where the action is, August 2017

1. Australian Bureau of Statistics (Census 2016).
2. Apportioned over an assumed population of 24.5 million as at August 2017.

The rise of long-term renting

Renting is the most common form of housing tenure for Millennials, Australia's so-called 'Generation rent'. Just 20.3% of Australia's 6.79 million Millennials owned their own home in 2014, well below the national average of 69.3%.[3]

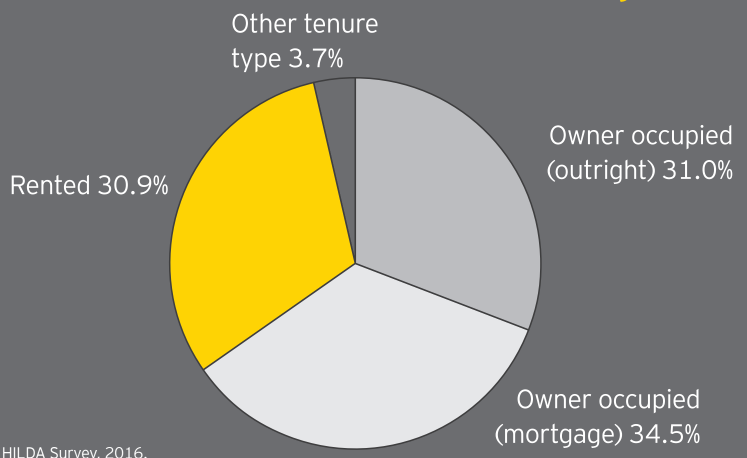
GRAPH 2: **Renters moving to home ownership**



Source: Australian Bureau of Statistics, 2018 (Census Data 2016)

Generation Z, scarred by the global financial crisis, shy away from large debt and are more comfortable with fractional ownership and sharing. Importantly, as home ownership becomes less accessible, this generation increasingly sees housing as a service.

GRAPH 3: **National tenure as % of dwellings**



Source: HILDA Survey, 2016.

This decision to rent is driven by a range of factors from affordability to convenience.

Low-cost: renting is often a more affordable option than a mortgage.

Flexibility: a finite lease means more options for overseas travel, new relationships, study or career opportunities.

Feeling rich: extra discretionary spending on lifestyle fosters non-financial wealth.

Maintenance: building management obligations and expenses are passed on to landlords.

Location: desirable inner-city locations that would otherwise be unaffordable are within rental reach.

Liquidity: capital is not tied up in a primary place of residence.

3. Source: HILDA Survey, 2017

Traditional private rental in transition

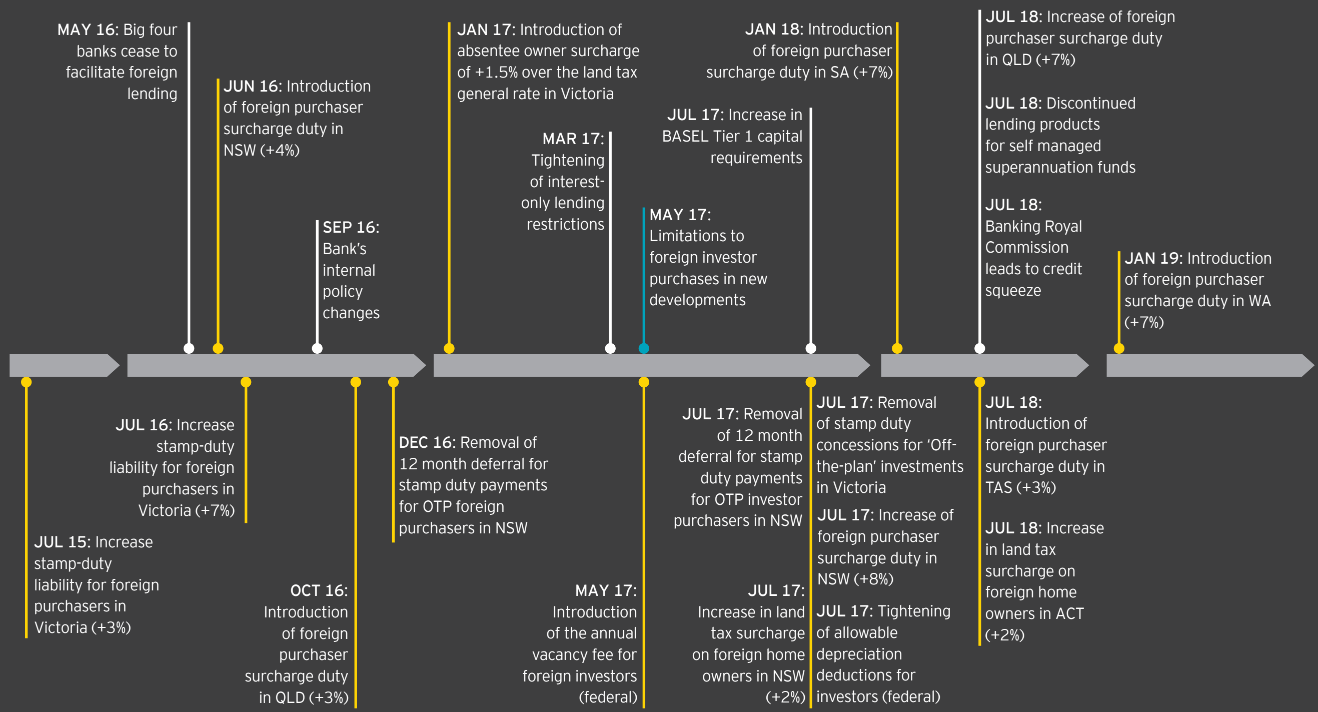
The private rental market has supplied rental housing for generations of Australians.

According to the Australian Housing and Urban Research Institute, the private rental market grew by 38 per cent between 2006 and 2016 – making it the fastest growing segment in our nation's property market.[4]

Since the 1980s, negative gearing provisions have enabled investors to deduct any losses from residential investment properties from their personal income. This policy has delivered broader market benefits by increasing supply, maintaining affordable rental prices while driving property price growth.

In response to sustained political, public and media pressure, unprecedented state and federal government policy and regulatory intervention has aimed take the 'heat' out of the residential property market.

FIGURE 1: Timeline of policy and regulatory events affecting the delivery of new housing



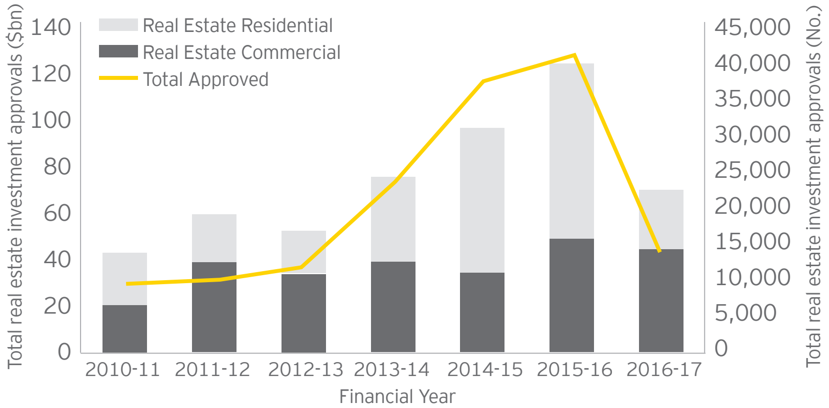
4. Source 'Private rental in transition: institutional change, technology and innovation in Australia' Source: Australian Housing and Urban Research Institute.

Over the past two years, changes to policy – state, federal, fiscal and lending – has led to the 'cool-down' of the private investor market. As a consequence, the off-the-plan apartment market has pulled back from providing rental supply.

All these interventions have disrupted investor activity and eroded the value of Australia's housing market – equating to a combined $13 billion erosion in value in the three months to July 2018.[5]

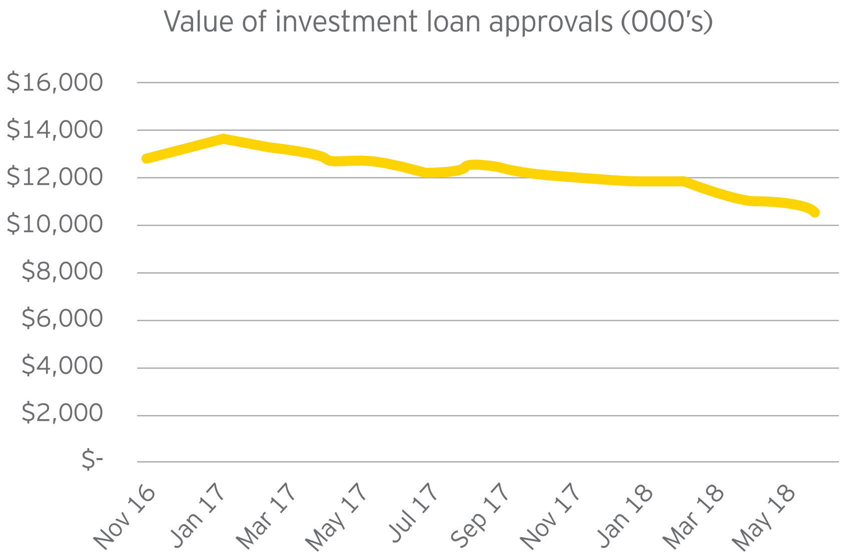
Investors – both foreign and local – have been discouraged from investing in residential housing, which is reflected in the declining investment approvals over the last 24 months.

GRAPH 4: Foreign Investment Review Board real estate investment applications



Source: Foreign Investment Review Board, 2017

GRAPH 5: Value of investment loan approvals nationally



Source: Australian Bureau of Statistics, 2018

As a flow-on effect, we are seeing a significant slowdown in the construction of new residential stock. With less investors in the market, developers are struggling to reach the pre-sales hurdle – typically 80% – required by banks to obtain construction finance.

This may take years to rectify and could stimulate house price growth due to compounding housing shortages.

Some analysts predict rental vacancy rates will also tighten to around 1% in some cities, placing upward pressure on rents.

5. Source: Australian Bureau of Statistics property price index to July 2018.

Can institutional multifamily housing turn the tide?

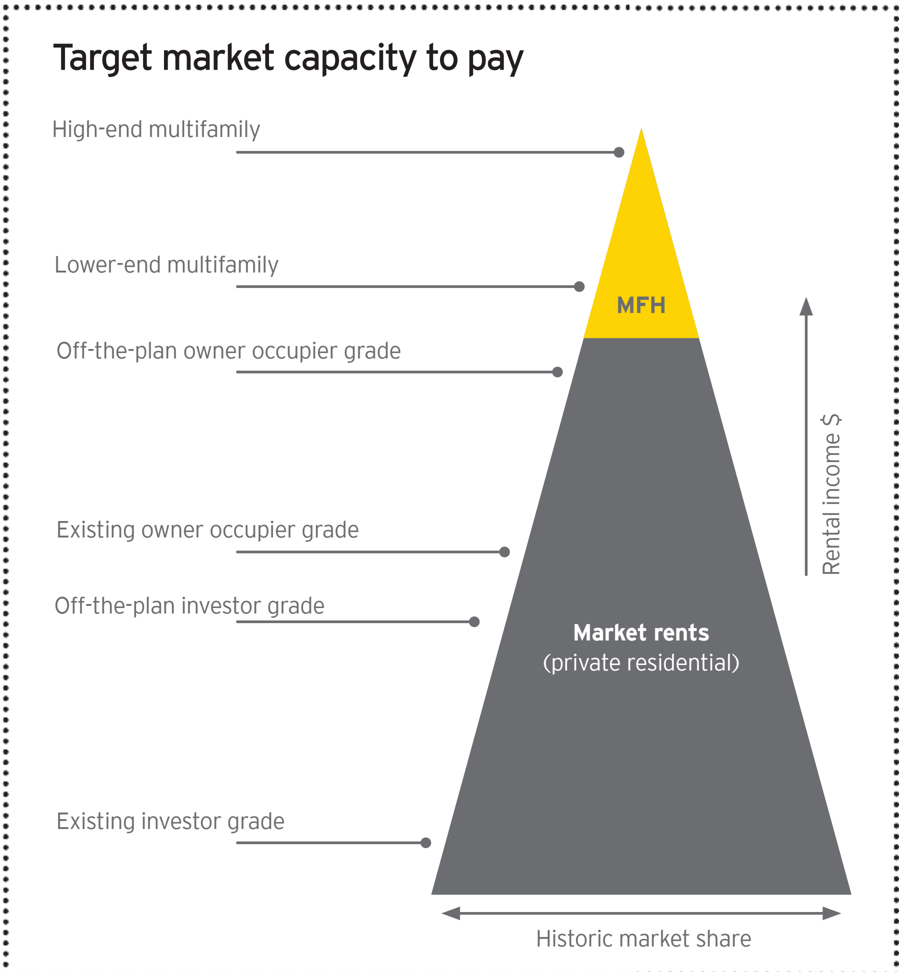
Multifamily housing (MFH) is a sub-sector of the build-to-rent asset class, which includes social and affordable housing, purpose-built student accommodation, co-living and retirement villages.

What makes multifamily housing special?

- **A distinct demographic target:** By designing a development around a specific target market or family cohort, facilities and services appeal to that audience. One demographic may want onsite day care and dry cleaning, another pet minding and a fitness centre, and a third rooftop gardens and concierge services.
- **Importance of a good brief:** The design of build-to-sell projects in Australia are typically led by the architect, with input from the developer. In this model, the construction company is generally the last stakeholder to provide input. However, multifamily housing design demands closer collaboration between the construction company and the developer, which is generally also the manager. While architects play an important role, they do not typically lead the design discussion.
- **A new business model:** The multifamily housing business model moves away from one-off development profit and towards annuity-style income. The high levels of customer service – with professional onsite management and a variety of resident amenities – drives both premium gross revenue and increased resident retention on lease expiry.
- **Housing at scale:** Multifamily housing requires significant equity investment, which is the domain of institutional investors like superannuation and pension funds. Operating on extremely tight margins, these investments require scale – which is why the minimum size for a standard multifamily project is around 300 to 350 apartments. As such, activation of large-scale investment is likely to originate from overseas funds.
- **Low and stable returns:** Gross yields in Australia are around 6.5% and allowing for operational expenses of approximately 30%. The result is net yields of 4.0-4.5% and equity internal rates of return of between 8.5% and 10.50%. With yields this tight, the taxation impost on multifamily structure could be the difference between an undersupply of rental accommodation and a billion-dollar asset class in Australia.
- **Lower risk and longer investment horizon:** Current institutional investors are increasingly favouring the risk profile of multifamily investment that diversifies long-term risk and maturity matching, allowing investors to service their longer-duration liabilities and achieve longer-term objectives.

Can institutional multifamily housing turn the tide? (cont)

Multifamily housing is designed specifically for renting rather than for sale, is owned and managed by institutional investors (such as superannuation or sovereign wealth funds) and delivers high levels of service to tenants.



Multifamily housing will not replace build-to-sell product, nor will it be the single solution to social and affordable housing shortfalls. However, as institutional investment is injected into the sector, governments may be able to circumvent the looming housing shortage to encourage large-scale housing development, including affordable housing, to be delivered in a relatively shorter period.

Bringing build-to-rent to Australia

Multifamily housing has succeeded in markets where government incentives – including those for affordable housing – have encouraged its establishment and growth.

Currently, Australian tax legislation does not encourage this new asset class.

Initial capital required to invest in multifamily housing is expected to come primarily from offshore institutional investors, where the asset class is well-established and well-understood.

But current legislation before Australia's Parliament will see Managed Investment Trust withholding tax on rental income and capital gains from multifamily housing assets increase from 15% to 30%.

Land tax, GST and other indirect tax costs in the construction and the operation phases can also diminish the economic return of multifamily projects.

What's more, in addition to stamp duty payable on the acquisition of land, a foreign purchaser surcharge of up to 8% may be paid, depending on the state or territory where the property is located and on the percentage of foreign ownership. While there are certain concessions and exemptions, these are granted at the discretion of the relevant state's tax commissioner.

Without appropriate taxation reform that treats multifamily housing assets like other core assets such as commercial or industrial developments, global capital may look elsewhere.

Make your move on multifamily

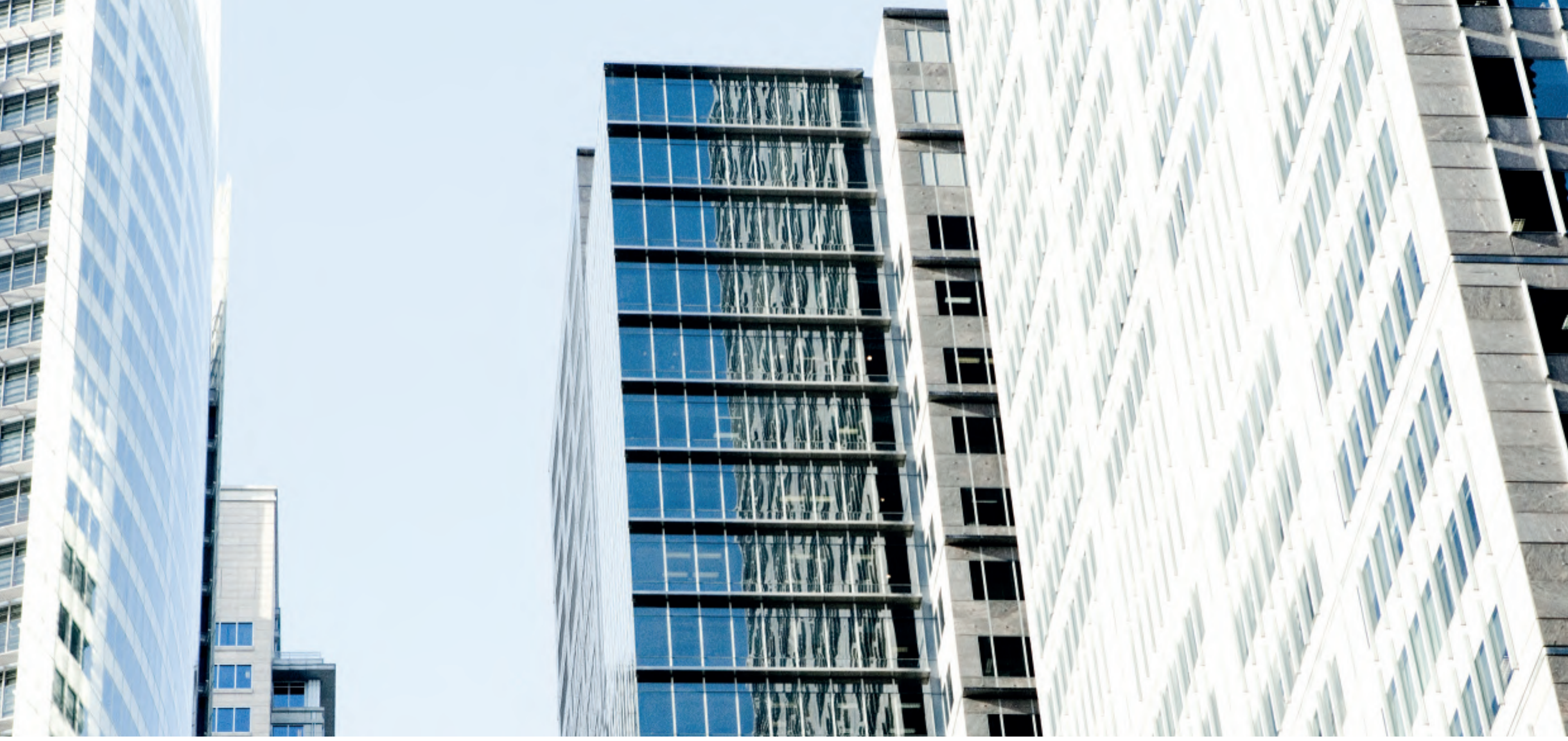
The time is right for Australia to establish a multifamily asset class.

Multifamily housing appeals to institutional investors as it provides high-quality, risk-adjusted returns and adds diversity to portfolios.

1. It's not a matter of if, but when MFH takes hold here in Australia. With the BTS product slowing there is an opportunity for good quality developers to adapt their business model to suit MFH. Understand the differences and be ready for change.
2. As we have seen in the UK and the US, institutional capital investors tend to partner with a development company to deliver MFH product. It is critical to understand the difference in BTS to BTR, understand the design required to deliver successful MFH product and know your sector and be prepared for change. Be willing to learn and listen to others.
3. Collaboration is the key to a successful design. Establish a design standard brief clearly articulating your values, design principles etc. A successful project requires early collaboration between the construction company, management/developer and the design team to ensure a product is suitable for the market it will operate in.
4. Know your product. MFH is about delivering the right product in the right location for the right price. Look at your portfolio of property and choose the development site which will provide the returns sought by institutional investors. Institutional investors are looking for 'easy wins' for their first investment into MFH in Australia.
5. Understand your development feasibility and benchmark the types and scale of fees you are able to charge to an institutional investor including Development Management, Construction & Design Management etc. A detailed understanding and a clear articulation of the achievable rents is key to a feasibility that is profitable.
6. Understand your stabilised cash flows to ensure they are both believable and achievable. Don't underestimate your operational expenses, if you're not providing the services you will not achieve the premium rents, rental retentions and rental growth.
7. Management is key. MFH will require a total change to the way residential property is managed in Australia. Property managers are no longer managing buildings but managing people. This requires a different skill set with managers coming from outside the property industry including retail and hospitality.
8. Affordable housing needs to form part of the product being offered in a MFH project. Understanding how the product will form part of the offering and the cohort targeted is essential to understanding their ability to pay the rents being asked.
9. In every jurisdiction globally, MFH has only succeeded on scale where governments have provided incentives to both developers and investors. This incentive comes with the caveat of supplying a component of affordable housing. Governments have a chance now to put in place suitable incentives to ensure our private rental housing stock can meet the demands of the near future.
10. Understand your operational model which may include the developer leaving their development profit in the ownership vehicle and the establishment of both a property management and asset management operation.

While the sector will require billions of dollars in capital and supportive government policy, we are already seeing evidence that experienced global institutions are committing hundreds of millions of dollars to Australia to capture the first mover advantage.

Will your company be one of them?



EY contacts

To find out how EY can help you make a move on multifamily housing, contact:

Luke Mackintosh
Partner
Real Estate Advisory Services - Melbourne
Ernst & Young, Australia
+61 438 719 944
luke.mackintosh@au.ey.com

Marco Maldonado
Partner
Real Estate Advisory Services
Ernst & Young, Australia
+61 420 949 264
marco.maldonado@au.ey.com

George Stamoulos
Partner
Transaction Tax
Ernst & Young, Australia
+61 421 051 017
george.stamoulos@au.ey.com

Paul Tuckey
Director
Real Estate Advisory Services - Brisbane
Ernst & Young, Australia
+61 429 986 532
paul.tuckey@au.ey.com

Selina Short
EY Oceania Real Estate &
Construction Managing Partner
Ernst & Young, Australia
+61 2 8295 6880
selina.short@au.ey.com

Ryan Costin
Associate Director
Real Estate Advisory Services - Melbourne
Ernst & Young, Australia
+61 448 086 811
ryan.costin@au.ey.com

Daryl Choo
Partner
Transaction Tax
Ernst & Young, Australia
+61 404 035 825
daryl.choo@au.ey.com

James Choi
Director
Indirect Tax
Ernst & Young, Australia
+61 402 781 043
james.choi@au.ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY Transaction Advisory Services
How organisations manage their capital today will define their competitive position tomorrow. We create social and economic value for EY clients by helping them make more informed decisions about strategically managing capital and transactions.

EY has one of the largest integrated real estate, hospitality and construction services of any accounting organisation, with approximately 10,000 professionals around the globe providing professional services to real estate owners, investors, lenders and users – including fund managers, institutional investors, REITs, developers and builders.

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

APAC no. AU00003467
S1009799
ED None

ey.com/au