SUBMISSION

Submission to the Victorian Government Build-To-Rent Industry Working Group

11 July 2019

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11 July 2018

Dear Ms Auster,

ASFA submission to the Victorian Government Build-To-Rent Industry Working Group

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission by way of contribution to the Victorian Government Build-To-Rent (BTR) Industry Working Group.

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its $2.8 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing over 90 per cent of the 16.1 million Australians with superannuation.

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If you have any queries or comments in relation to the content of our submission, please contact Julian Cabarrus, Director of External Affairs & Strategy, on (02) 8079 0815 or jcabarrus@superannuation.asn.au

Yours sincerely

Dr Martin Fahy
Chief Executive Officer

General comments

Over much of the last decade Australian house prices have increased rapidly and there has been an increasingly acute focus from Federal and State Governments on tackling the public policy challenge of housing affordability.

During this time, policy makers have considered the possible role of superannuation in addressing housing affordability issues, with a range of related policy options receiving attention in the broader public debate. The First Home Super Savers Scheme and the Downsizers Contribution measure were announced in the 2017 Federal Budget and subsequently implemented by Government.

ASFA has worked with its members to consider the interplay of superannuation policy and housing affordability policy. We welcome the Victorian Government's consultation on barriers facing the BTR sector, as part of its broader consideration of initiatives with the potential to change the housing mix, unlock supply of new dwellings and increase the diversity of housing options available.

There is scope for superannuation to participate in the BTR sector as a significant institutional investor of long-term, patient capital. However, superannuation funds must first determine that capital allocation to the sector is in the best interests of their members.

Historically, there have been several barriers to superannuation funds investing in Australian residential real estate, with the embryonic BTR sector being no exception. In particular, the return profile of the sector has made it largely unviable for superannuation funds who are obligated to seek the best possible risk-adjusted returns for their members. However, some funds have been increasing investment in the sector overseas where investment returns have been sufficiently attractive.

The development of an active local BTR market could improve return profiles and create scalable opportunities for superannuation funds to invest in the development of BTR multi-family properties. In turn, the propensity of superannuation funds to hold residential property assets for the long-term could underpin ongoing market viability and leasing stability for renters, supporting the broader set of policy objectives government is seeking to address through the growth of the BTR sector.

This brief submission outlines the current barriers to superannuation investment in BTR, the risks of investment, and opportunities for market development that could generate increased levels of investment.

Barriers to investment

Definition

BTR should be defined as a specific property asset class and not, by default, conflated with social or affordable housing. A clear, demarcated definition of BTR has the capacity to increase the confidence of prospective investors in the sector. Whilst it is recognised that BTR has the potential to benefit housing affordability for renters through increased supply in the long-term, BTR must meet commercial objectives if it is to attract higher levels of broad-based institutional investment.

Returns

Ongoing income yields on residential property are very low in Australia and although capital growth has been strong over much of the last 20 years or so, it would be hard to assume that this sort of capital growth will continue going forward – that is, total returns currently in prospect would be unlikely to be very compelling for superannuation funds. Given current low interest rates and the ready availability of bank loans for residential housing, the possibility of superannuation funds using their scale to obtain sufficiently high risk-adjusted returns on residential property investment appears limited. There is also a strong emotional value in residential property which often reduces the investment opportunity.

Scale

In many cases there is a lack of scale to provide a viable asset class for wholesale investment, with this applying to both multi-family and particularly single-family residential properties. For larger super funds, capital allocations need to be above a threshold level (for example, $100m) to justify due diligence costs and achieve meaningful deployment and sufficient diversification. This would require the acquisition of many residential properties with all the associated responsibilities in regard to maintenance and management of tenants.

Need

The residential property market is well serviced by builders, constructors and developers who appear to have ready access to finance via banks and capital markets. Supply constraints are more about land availability than shortage of finance. Such investment is typically financed on a risk scale (pro-cyclical, very high leverage) well above what superannuation funds would seek as part of long-term diversified portfolios.

Market settings

The many economic incentives for individuals to own property impacts the economics of residential real estate and makes it relatively less economically attractive to institutions. Several incentives available to individuals are not available to institutional investors and this tips the economic benefit to the individual.

Risks of investment

Concentration risk

Superannuation members collectively have a large exposure to residential real estate through direct property holdings or bank exposures in their superannuation. More residential housing investment by superannuation funds will increase what is generally viewed as an existing overexposure.

Investment cycle risk

At this juncture it is prudent to consider the overall level of indebtedness of Australian households, fuelled amongst other things by housing market debt, as there may be a very large and possibly unpriceable tail risk for residential housing investment. Putting more superannuation fund assets into an area directly at risk from the impact of a need to unwind that debt, is risky.

Managing and leasing risk

Leasing and property-management is labour-intensive, specialised and heavily reliant on partnering with quality operators. The management intensity of residential is much greater than commercial and even more so for BTR developments. The market for quality operators with the ability to service institutional investors is deep in the commercial property sector but limited in residential.

Unintended consequences

Any increase in demand from superannuation funds for residential housing could place upward pressure on house prices with subsequent implications for housing affordability.

Opportunities for market development

While there are number of constraints on the ability of superannuation funds to support the BTR sector, there also are opportunities for superannuation funds.

Improving risk-adjusted returns

Superannuation fund investment in BTR residential property has the potential to provide high-quality, affordable rental market supply with greater certainty of tenure for renters. Institutional investors can take a longer-term perspective than individual investors. Superannuation funds also could benefit via access to a diversified, visible and consistent long-term rental income stream.

However, institutional residential real estate hasn't developed in Australia to any great extent due to a cultural and economic desire for individuals to own property (either to live in or as an investment) which creates sufficient retail demand to provide developers with a liquidity option that is probably easier than having to sell a package of properties to institutions.

In general, prospective returns from a BTR model are not as attractive as those from a "Build to Sell" model. By way of example in the UK, Build to Sell typically delivers a development return of circa 17.5% Internal Rate of Return, whereas BTR delivers approximately 7.5%, well below the 10-12% that institutions would require to justify the development risk.[1]

However, market development of institutional investment in BTR could be facilitated by Government by:

- providing exemptions from land tax
- offering exclusive tendering or other concessions such as planning and zoning approvals
- making public sector land available for purchase at a discount to market value
- contributing to the development of public spaces and amenity
- underwriting a level of occupancy in a long-term leasing environment

These measures would lower the cost base and improve the return profile of the sector, making BTR more attractive to institutional investors on a risk-adjusted basis.

In return for these concessions, investors could be required to offer leasing stability and inflation-linked rental adjustments, improving tenure and affordability for the growing number of Australian renters. Leases may also contain options to purchase, enabling ownership where sought.

The idea of building residential estates and holding the properties under a trust owned by super funds has merit for further consideration. If the funds did the development themselves, much of the profits normally made by property developers would be included in the return to the superannuation funds. If the superannuation fund can build such developments at a lower cost due to the scale of their activities, then the rents could be lower than market or an affordable housing component could be established.

Liquidity would not necessarily be a material barrier for superannuation funds, who have illiquid allocations within their existing portfolios that could be complemented by investments in unlisted residential property. Stable multi-family properties with scale would also provide a relatively liquid rental income stream.

[1] UBS, October 2016

Government intermediaries

A government intermediary would help facilitate institutional investment in residential housing. The right planning is particularly imperative for the BTR and affordable housing sectors in order to achieve desired market and social outcomes.

The UK has had success with this model as much of the long-term debt finance has interest rates which are inflation linked, with such debt in high demand by UK defined benefit funds in run off.

The Federal Government established the National Housing Finance and Investment Corporation (NHFIC) following the 2017-18 Federal Budget, with its first social housing bond issue of $315 million occurring in March 2019.

Government intermediation also has the potential to be especially valuable in terms of providing assistance in zoning and planning. If land was specifically zoned, or planning made conditional such that only a BTR scheme was permitted, it would be priced accordingly on the potential long term income streams, and would effectively crowd out 'Build to Sell' operators. Another model could be making brownfield public sector land available for purchase by BTR investors, at a discount to market value.

A Government could perhaps underwrite a level of occupancy in a long-term leasing environment, but governments tend not to want to take on this type of risk. Vending in land for a development and contributions to development of public spaces and amenity could be a more palatable approach, but the overall expected returns would still need to be in the best interests of superannuation members.

Real Estate Investment Trusts (REITs) and securitisation

Many REITs that invest in the residential market are in the 'develop and flip' space – they are not long-term owners of residential property and need to constantly refresh their land banks to provide for future development stock.

REITs generally need cash flow positive assets that allow them to achieve dividend yields commensurate with general market requirements. However, the income yields for the Australian residential property are so low such that without the negative gearing and expectation of capital uplift, the residential assets would not be attractive.

Residential Mortgage Backed Securities (RMBS) represents a form of securitisation of residential property mortgages which is a successful product to fund property ownership in Australia and globally. The Australian RMBS market is valued at around $95 billion.

Securitisation of the equity ownership may be an option although it would have to deal with the subordinated position of equity relative to any mortgage debt in place on the residential properties and as such may be rather complex.

Securitisation would provide the ability to buy or sell the securities easily therefore providing liquidity. Additionally, securitisation would also provide the ability to separate the cash flows from ownership of the assets. For example, the assets can be owned by one entity (could be public, private or hybrid) but the construction of which is funded by the selling of future cash flows through securitisation to other entities (including superannuation funds).

Creation of a securitised market would need to be managed appropriately with the right balance of regulation and oversight.

Debt investment

Subject to still meeting risk-adjusted return objectives, debt investment is another potential pathway that could form part of a superannuation fund's overall portfolio construction. Debt, of course, also carries a set of unique risks and would require partnering with well established, credentialed, stable and long-term developers and managers - which still requires the right policy settings and incentives to attract. As well as considering the BTR opportunities from a direct superannuation equity investment perspective, a partnership or consortium perspective, with superfunds supplying debt investment, is worth exploring.