PROSPECTS FOR

BUILD TO RENT

IN NEW ZEALAND

THE INTERNATIONAL CONTEXT

CBRE

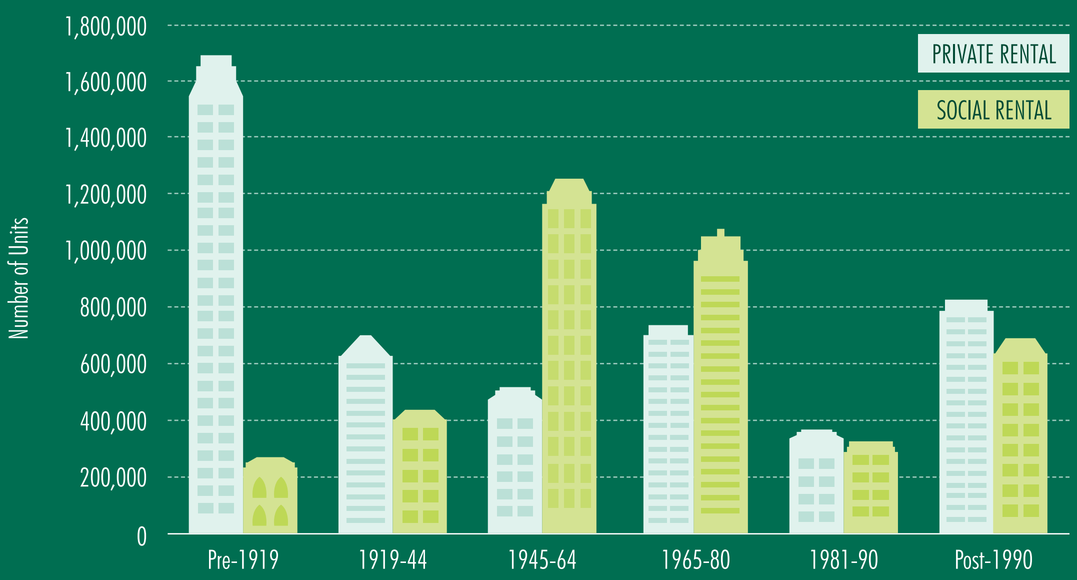
THE FIRST IN A SERIES OF BUILD TO RENT REPORTS BY CBRE RESEARCH NEW ZEALAND.

Zoltan Moricz
Head of Research

Tamba Carleton
Senior Research Analyst

Over the past century, the provision of rental housing has evolved in similar ways across multiple housing markets. Figure 1 illustrates the UK experience but provides a fairly universal background that also applies to New Zealand. Pre-WW1, there was little involvement from governments in accommodating citizens, with almost all rental housing controlled by the private sector. Post-WW2, the welfare state took a significant role in the provision of social housing. This approach was dismantled from the 1980s reflecting the sociopolitical shift towards neo-liberalism and free market models, and in the last 30 years rental housing has once again became an increasingly private sector endeavour. This provided the context for increased corporatisation of the rental housing sector with the latest evolution being the increasing global focus on build to rent housing.

FIGURE 1: UK RENTAL STOCK BY COMPLETION YEAR



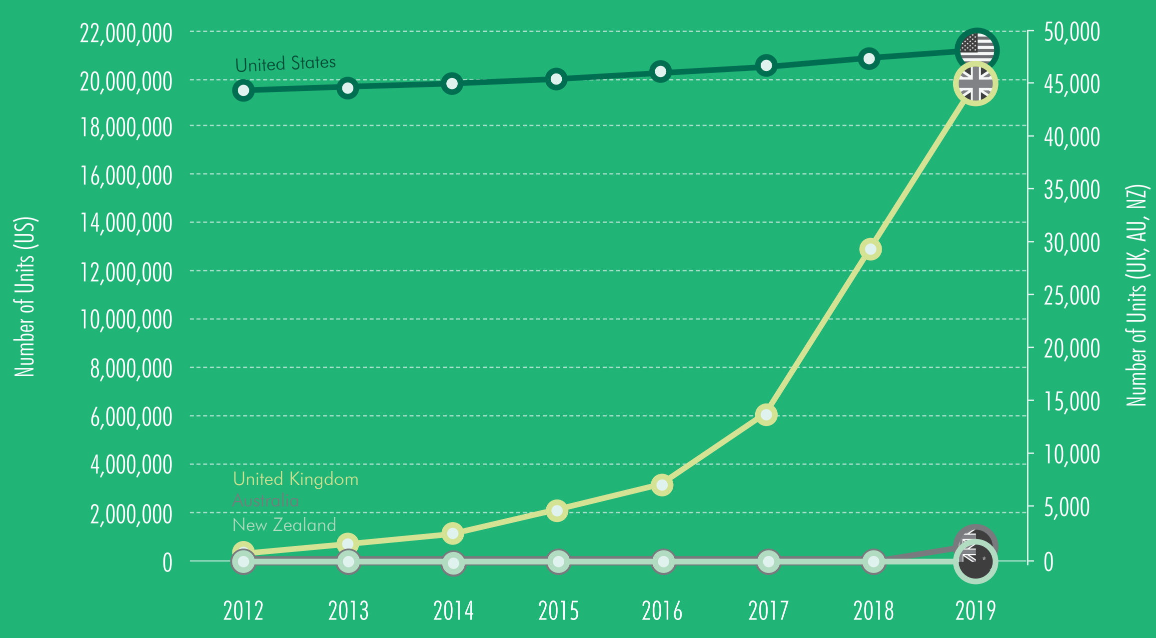
Source: English Housing Survey

Build to rent is defined as multi-unit residential developments that are designed and built as long-term rental housing with a single ownership entity. It is an established asset class in some major markets such as the US and UK and has been gaining traction in Australia. Overcoming constraints around build to rent development enables growth in housing stock to accommodate a growing renter population of people who are unable to or unwilling to purchase a residential property. Build to rent has growth potential in New Zealand and is increasingly being considered as an alternative asset class. The local market is in its infancy, with a handful of developments planned, underway, or recently completed. This research paper examines the prospects for build to rent in New Zealand, referencing overseas contexts to identify the challenges and opportunities in our unique housing market.

SIZE AND STRUCTURE OF INTERNATIONAL BUILD TO RENT MARKETS

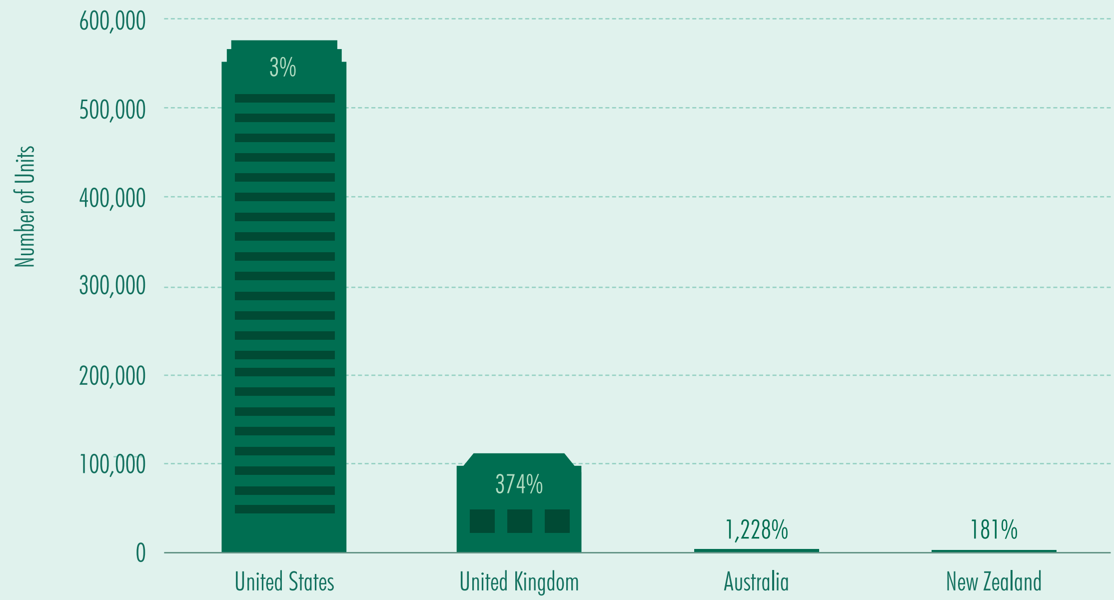
Build to rent is an established asset class overseas, however the product offer and operational structure can vary significantly between geographies. In this section, we consider the structure of the US, UK and Australian BTR markets and the implications for BTR in New Zealand.

FIGURE 2: BUILD TO RENT STOCK BY COUNTRY



Sources: National Multifamily Housing Council; Urbis; CBRE

FIGURE 3: BUILD TO RENT SUPPLY PIPELINE WITH % STOCK GROWTH



Sources: British Property Federation; CBRE

TABLE 1: SIZE OF INTERNATIONAL BUILD TO RENT MARKETS

				
Stock	20,830,586	29,416	217	96
CBD	2,975,798	2,493	0	0
Suburban	17,854,788	26,923	217	96
CBD %	14%	8%	0%	0%
Suburban %	86%	92%	100%	100%
Low Rise	15,356,634	28,606	0	49
High Rise	5,473,953	810	217	47
Low Rise %	74%	97%	0%	51%
High Rise %	26%	3%	100%	49%
Studio	809,256	4,804	0	0
One Bed	9,436,107	9,553	12	29
Two Bed	8,778,101	7,927	175	42
Three+ Bed	1,807,122	7,133	30	25
Studio %	4%	16%	0%	0%
One Bed %	45%	32%	6%	30%
Two Bed %	42%	27%	81%	44%
Three+ Bed %	9%	24%	14%	26%
Pipeline	579,300	110,092	2,665	174
Dominant Area	California	London	Melbourne	Auckland

Note: UK proportions based on all privately rented dwellings

Source: CBRE

Build to rent comprises around 21 million dwellings. The initial post-WW2 development phase focused on smaller, less costly projects in the suburbs, driven by development fundamentals and occupier demand. It was during this time that inner city areas were often perceived as unsafe areas offering poorer lifestyle and amenity compared to the suburbs. Subsequently, the sector has matured from predominantly low and medium density garden apartments to now be mostly large scale, high rise residential. However this is a relatively new trend and the bulk of existing stock remains low rise suburban, as shown in Table 1. Major investors include Goldman Sachs, Morgan Stanley, JP Morgan, Metlife, UBS, USAA, AEW, Blackstone, Brookfield, and Deutsche Bank, to name a few. Greystar is the only national manager, with others such as Pinnacle and Lincoln being more regionally focused.

There are 24 million residential dwellings in the UK, of which 9 million are rental properties. Private rentals comprise the bulk at around 5 million properties with social rentals comprising the remainder. A large volume of social housing was constructed between 1945 and 1980, often in the form of council flats or council estates, structured as secure tenures at reasonable rents for the working class. The Housing Act 1980 gave council tenants the right to buy their property at a discount to market value, which varied depending on how long they had lived there. This has since reduced the pool of social rental stock and made way for a resurgence in private rental construction.

Build to rent emerged in the UK approximately seven years ago with the first major project being the conversion of the London Olympic Games Village into 1,400 affordable rental units. This was effectively a large-scale experiment that worked. The success of the Olympic Village conversion encouraged other developers and market participants to consider entering the build to rent space, and the size of the pipeline has since exploded due to local and national government support, having been identified as a means to increase the supply of housing in areas that were becoming increasingly unaffordable. Stock has grown around 20-fold to approach 30,000 units, with a pipeline of more than 100,000 units either in planning or under construction. Major market participants include Get Living, Grainger, Criterion Capital, Quintain, L&Q, Sigma Capital, Apache Capital, and Greystar, to name a few.

Build to rent is widely regarded as having a role to play in housing shortages in Australia and has gained traction over the past couple of years with a handful of projects under construction and more with development approval. Most of these projects are in Sydney and Melbourne, with a lower level of activity in Brisbane and Perth. The largest build to rent project is the $550 million conversion of the Commonwealth Games Athletes Village on the Gold Coast. This project, called the Smith Collective, features 532 one-bed-one-bath apartments, 637 two-bed-two-bath apartments, and 82 three-bed-three-bath townhouses. There are interesting parallels between the UK and Australian build to rent markets, both being kickstarted with large scale athletes village conversions.

The current pipeline is being driven by local Australian institutional investors, such as Salta Properties, Grocon/UBS, Gurner, and Mirvac. While there are several offshore investors looking to enter the Australian market, none have an active project as yet.

OCCUPIER DEMAND DRIVERS

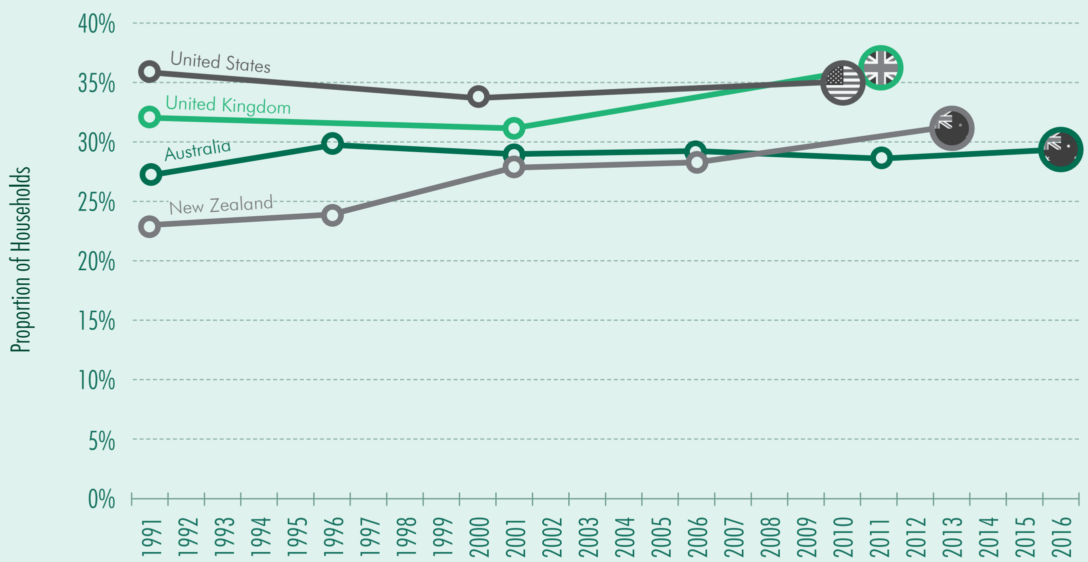
The occupier demand drivers that have triggered build to rent development globally are now present in the New Zealand market. Demographic, socio economic and lifestyle changes in the context of the current housing market has created opportunity for build to rent to emerge. One of the major drivers of demand is the growing number of renter households due to a combination of population growth, a declining home ownership rate and smaller household sizes. While some of these trends are cyclical and related to economic conditions (e.g. the net migration component of population growth), others are structural and reflective of the changing demographic makeup.

Home Ownership Rate

Home ownership rates in New Zealand grew through much of the last century however over the past 20 years this trend has reversed. As at the 2013 Census, the rate of home ownership was 64.8%. Home ownership peaked in 1991 at 73.8% following state intervention, which included access to low interest state mortgages and family benefit payments (ceased from 1991). Home ownership rates have been declining since the 1990s and are currently the lowest they have been in more than 60 years.

With declining home ownership rates, the proportion of renter households has increased. As at the 2013 Census, 31.2% of New Zealand households rented. While the New Zealand proportion of renter households is below that of the UK and US, it has grown the fastest amongst the four countries since 1991, creating increasing potential for build to rent to emerge.

FIGURE 4: PROPORTION OF HOUSEHOLDS RENTING - CENSUS DATA



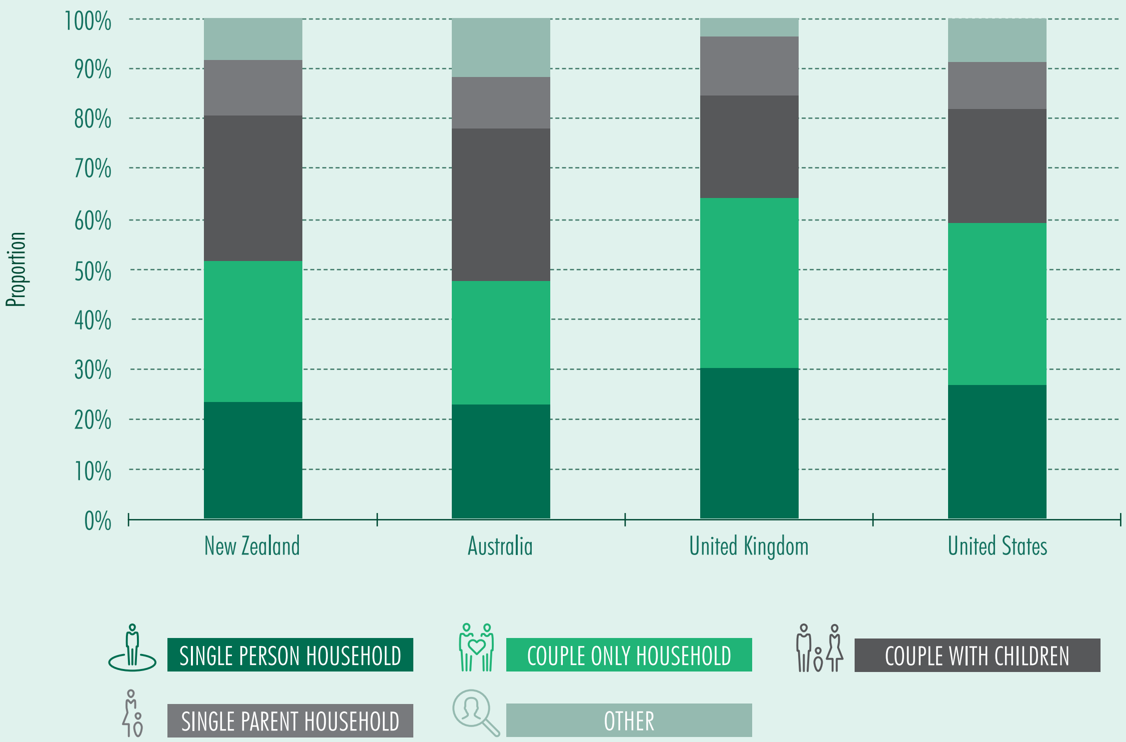
Sources: Australian Bureau of Statistics; Statistics New Zealand; Office for National Statistics; United States Census Bureau

Smaller Household Sizes

The increasing proportion of renter households is further supported by changing household typologies, with Kiwi households generally getting smaller. Statistics New Zealand predicts that by 2038, the average Kiwi family will be a couple without children, meaning that the current average family size is expected to decline. The couples without children household type includes couples who will never have children, couples who will have children in the future, and couples whose children have already left home. Delayed childbirth and longer life expectancy is contributing toward this trend.

Smaller households are generally more mobile than large households, particularly if they are childless. The flexibility benefit that renting allows over home ownership is more likely to suit the economic and lifestyle needs of smaller households. Declining household sizes create increased demand for housing even during times of stable population volume. In the New Zealand context where the population is growing rapidly, smaller family units provide an additional boost in demand for housing. This, combined with a fast growing proportion of renter households, is supportive of a shift toward a higher density residential environment.

FIGURE 5: PROPORTION OF HOUSEHOLD TYPES - CENSUS DATA



Sources: Australian Bureau of Statistics; Statistics New Zealand; Office for National Statistics; United States Census Bureau

SUPPORT STRUCTURES FOR BUILD TO RENT

When considering the potential for the emergence and growth of build to rent in New Zealand, it is important to recognise the institutional structures that have enabled and supported (or sometimes hindered) the asset class in other markets. The large size and rapid growth of the asset class in the UK and US is in large part due to supportive institutional structures. Without such support locally, it may be futile to point to these markets as useful precedents that back the likely evolution of the sector in New Zealand.

One of the structural elements supporting the rise of build to rent (known locally as multifamily) was a preferential mortgage market. Loan terms, leverage and pricing are more favourable for multifamily than other property types. Unlike other property sectors, the multifamily sector benefits from US government-backed lending programs with Fannie Mae, Freddie Mac and the Federal Housing Administration being major sources of debt capital for existing assets since the 1990s. Preferential treatment is demonstrated in lower mortgage rates and higher loan to value ratios for multifamily lending compared to other commercial real estate.

TABLE 2: US MULTIFAMILY AND COMMERCIAL REAL ESTATE MORTGAGE MARKET TERMS

	Commercial Real Estate	Multifamily
Mortgage Rate	4.50%	4.25%
Loan to Value	59%	67%

Sources: CBRE Research, Real Capital Analytics

Early build to rent growth in the UK was enabled in May 2013 with the establishment of Permitted Development Rights (PDR), which allowed the conversion of office buildings into residential without the need for planning permission. While the intention was to increase housing supply through the reuse of long vacant office stock, some conversions were of poor quality and have resulted in negative outcomes for tenants. Although they are still available, the use of PDR in build to rent development is declining as institutional investors are increasingly seeking scale. 30% of existing build to rent stock in London has been delivered via a PDR, compared to 9% of the pipeline.

Actions undertaken by the government to support and encourage build to rent have been a driving force of recent growth. These include mayoral endorsement of build to rent’s contribution to housing stock in London, tax regime changes reducing the appeal of small scale, individual residential investment, and the ability for developers to offer affordable private rent in place of other affordability requirements stipulated in the local planning rules. The recent release of the draft New London Plan detailed a standalone policy on build to rent, representing a major step in support of the long term establishment of the sector. This planning update is expected to make obtaining approval for new large scale BTR easier, further reducing reliance on PDRs.

Although the volume of Australian build to rent stock and pipeline size is growing, speed of growth has been restrained by build to rent's tax disadvantaged status, planning regulations and ultimately financial viability. Taxes affecting build to rent disproportionately include land tax that is payable in perpetuity, non-recoverable GST, and withholding tax set at the company tax rate for non-resident investors. Planning barriers include the length of time between applying for and receiving development approval, minimum unit size restrictions and design restrictions. These factors increase development cost to reduce project viability.

Financial modelling by CBRE has shown that the impact of Australia's withholding tax, land tax and GST on build to rent developments reduces IRR by 2.4 percentage points, delivering a return 25% lower than if those tax regimes were more supportive of build to rent. While Australian build to rent is negatively impacted by all three taxes, developer returns on build to sell are not eroded by land tax and GST costs, and commercial real estate receives GST and withholding tax concessions.

Although build to rent's emergence in Australia has not progressed at the expected speed due to a suboptimal support structure, the sector has made progress over the past couple of years to comprise over $1.6 billion dollars of planned projects in major Australian cities. Projects that are in the development pipeline are overcoming tax and planning obstacles in different ways. For NSW projects, the effect of the 2% premium land tax is reduced by developing on fringe and suburban sites with lower unimproved land values. Active projects are of scale and average over 250 units (excluding the 1,251 unit Gold Coast Athletes Village).

To date there has been no explicit government legislation or banking sector policy enacted that could support build to rent in Australia. However, both the state and federal governments are starting to recognise the importance of this sector and there seems to be an emerging focus into how they can support it. In mid-2018 draft legislation was announced that would enable build to rent investment via a Managed Investment Trust, allowing institutional investors to take advantage of a withholding tax rate set at half of the normal company tax rate. However, this lower tax rate of 15% applies to local investors only. Non-residents are allowed to invest in commercial property via a Managed Investment Trust at the 15% tax rate but are liable for the full tax rate of 30% with BTR investment. This, at least for now, is hindering overseas institutional investment into the sector.

In New Zealand, natural support structures such as demographic change and investment rationale are present, however the institutional support structures that have been essential in the growth of mature build to rent markets offshore are not currently present.

As in Australia, tax related issues, principally concerning GST, are seen as hindering build to rent locally. This potentially puts the build to rent market at a tax disadvantage compared to the build to sell market. Unlike the US, there is no preferential mortgage market for lending on apartments; local build to rent projects to date have relied on institutional and private equity investment, supported by construction finance. The UK build to rent market has grown exponentially off a supportive regulatory framework actively created by the government, and the absence of government support for build to rent dampens its growth potential in New Zealand.

INVESTMENT RATIONALE

On face value build to rent is hindered by relatively low initial income yields compared to commercial and industrial property. However, when consideration is given to other aspects of property investment, including higher average occupancy rates, diversification/countercyclical benefits, lower return volatility and favourable capital returns, the investment rationale for build to rent improves.

Vacancy

Residential vacancy rates are lower than commercial property vacancy rates. New Zealand office, industrial and retail vacancy rates average around 2.5%-6.5%, with variation depending on location and quality grade. In contrast, Auckland residential rental vacancy is estimated to be around 2.0%. This is a similar trend to major build to rent markets, which also show lower residential than commercial/industrial vacancies. Incidentally, based on residential letting agency feedback, New Zealand's residential vacancy rates are below those prevailing in major build to rent markets.

FIGURE 6: COMPARATIVE VACANCY

* CBRE estimate from residential real estate agent feedback

Sources: United States Census Bureau; Ministry of Housing, Communities and Local Government; SQM Research; CBRE

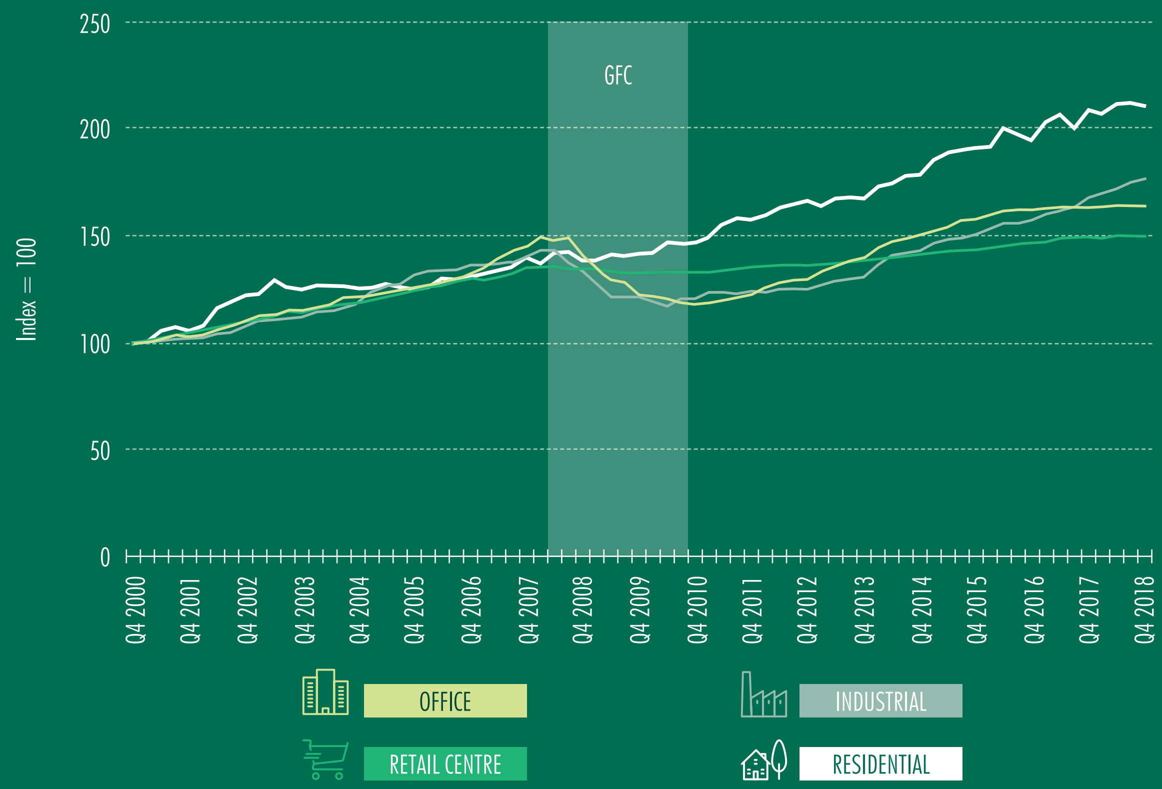
Diversification

Internationally, investors seeking diversification and risk adjusted performance have been attracted to the sector, with US multifamily comprising 29% of all institutional investment into property between 2010 and 2016, the second largest allocation behind office at 30% and well ahead of retail at 17% and industrial at 12%. Institutional investment has contributed to a shift in development focus to high quality CBD high rises as these types of developments fit better with portfolio requirements.

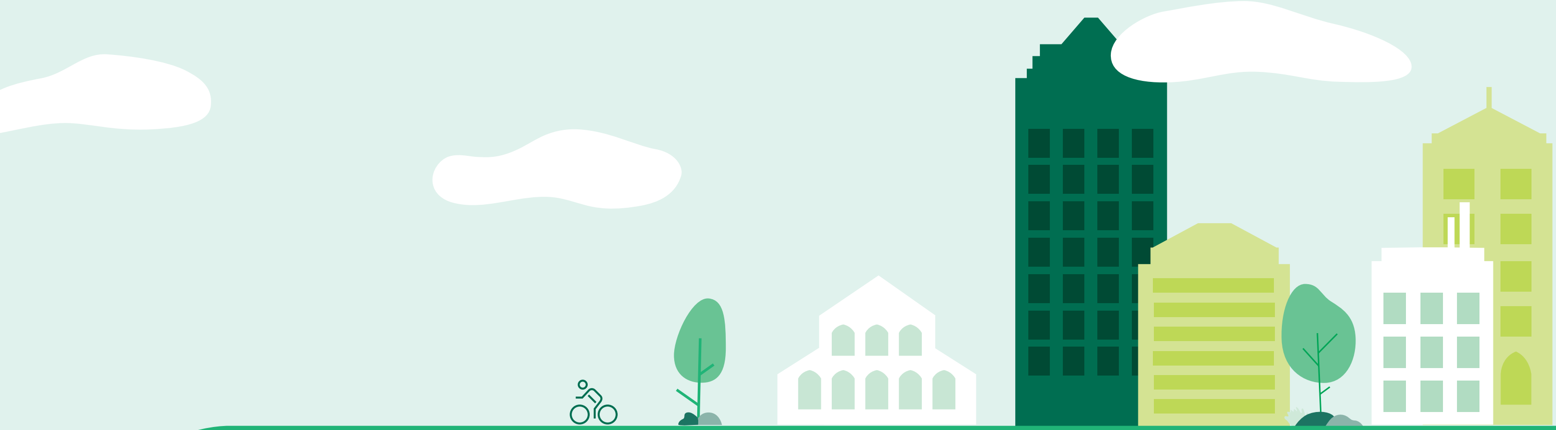
Rental Growth

Auckland residential rents have experienced higher growth than commercial/industrial property with considerably less volatility. Historically, when New Zealand has experienced economic downturns and commercial/industrial property sectors have had rental declines, residential rents outperformed. This stability of income during weaker economic times makes build to rent attractive to investors who are seeking portfolio diversification benefits, higher capital returns and favourable risk adjusted returns.

FIGURE 7: AUCKLAND RESIDENTIAL VS. COMMERCIAL/INDUSTRIAL MARKET RENT GROWTH



Sources: MBIE (residential rents referring to two bedroom units in Auckland); CBRE



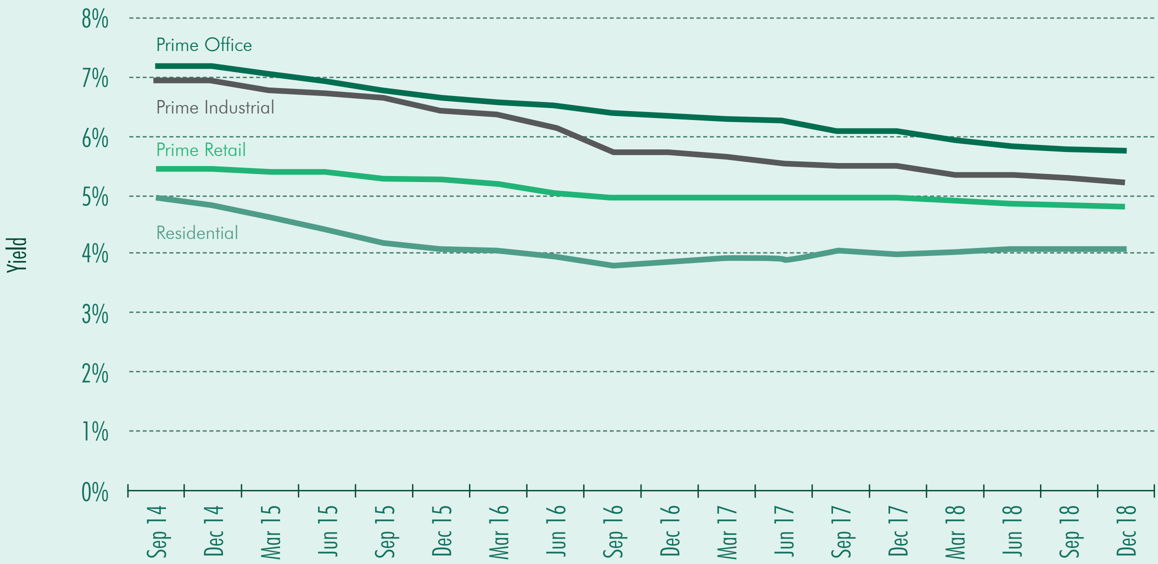
Cash Flow

From a cash flow diversification perspective, build to rent has advantages over other commercial property types. The large number of sources for cashflow generated in a build to rent means that the departure of a single tenant has little impact on the overall level of income. The wide variety of sources for build to rent cashflow also allow letting rates to be constantly updated to market via relatively higher levels of churn. This allows the space to be filled at current market rates, where other types of commercial property are more reliant on pre-agreed rental increases terms at the start of a lease. This is especially important in light of the favourable rental growth trends exhibited by the residential sector.

Yield

Residential has historically been characterised as a low-income yield investment. This remains true, however, given the more significant yield compression evident in the commercial/industrial sectors in the last few years residential income returns have become more competitive relative to other investment classes. Although residential yields are low, their position relative to other asset classes has boosted the profile of build to rent as a potential alternative. Auckland residential rental yields, and by extension build to rent yields, are likely to be around 4%. This is a slight improvement on income yields a couple of years ago, as asset prices have stabilised while rents continued to increase, although remains 100-300 basis points below commercial/industrial income yields

FIGURE 8: AUCKLAND INVESTMENT YIELD BY SECTOR



Sources: interest.co.nz; MBIE; REINZ; CBRE

Total Returns

To assess build to rent relative to other asset classes, total returns provide a better comparison than yield. In the US, over the long term (25 years from 1992-2017) multifamily delivered higher total return at lower volatility than other asset classes.

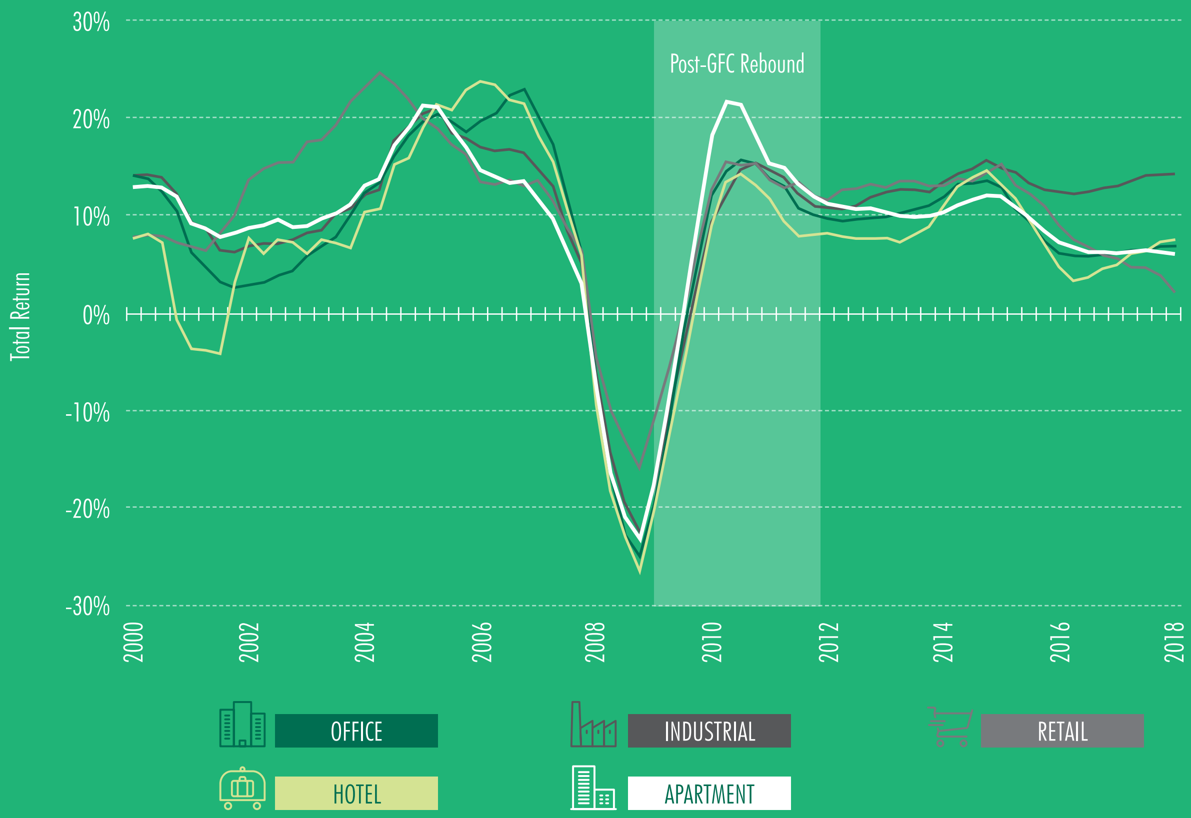
TABLE 3: AVERAGE ANNUAL RETURN AND STANDARD DEVIATION BY PROPERTY TYPE FROM 1992 TO 2017

Sector	Average Total Return	Standard Deviation
Multifamily	9.75%	7.75%
Hotel	9.61%	8.36%
Industrial	9.57%	11.03%
Retail	9.44%	7.38%
Office	8.38%	9.64%

Sources: CBRE; NCREIF

The US market experience is also consistent with New Zealand with regards to build to rent's countercyclical investment benefits. During the GFC, many Americans moved out of ownership property and into rental accommodation. This resulted in rising rents and falling vacancy from 2010 onward. Strong occupier demand meant that multifamily total returns did not decline as much as some of the other sectors and that they bounced back the highest by far.

FIGURE 9: US REAL ESTATE ANNUALISED TOTAL RETURNS



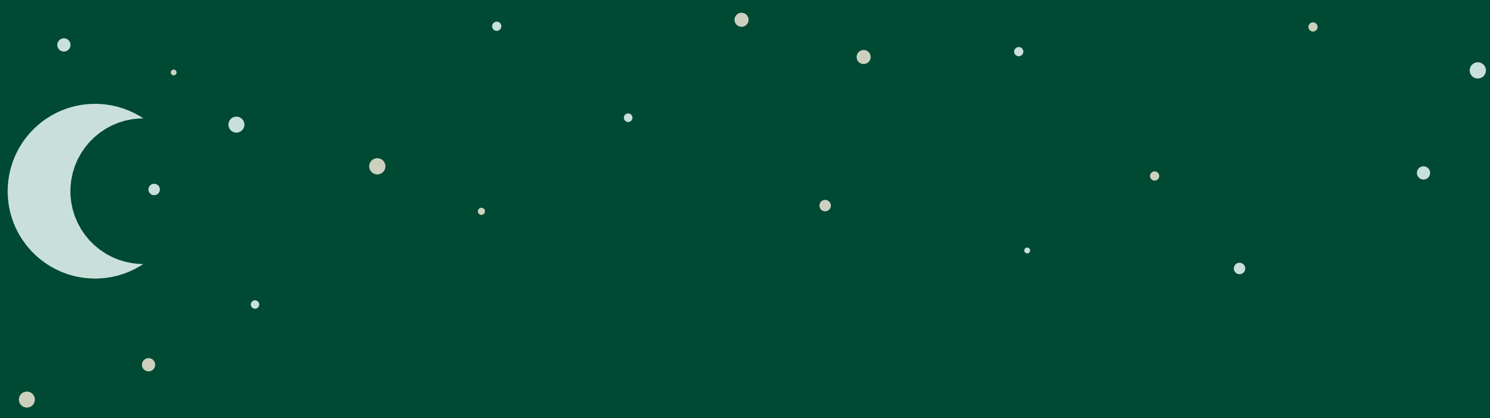
Source: National Council of Real Estate Investment Fiduciaries

CHALLENGES AND OPPORTUNITIES

Purpose built rental accommodation has been a feature of the Auckland housing pipeline for some time, working as a precursor to build to rent. In the early stages of the current cycle, one of the prevailing apartment development/investment models resulted in hundreds of self-contained studio apartments completed around West and South Auckland. These units were typically organised as 8-9 units per building, with individual buildings sold as managed rental accommodation to investors. These were complemented by a number of developments intended to be held by the developer for rental purposes, however none of these examples have explicitly featured as BTR. More recently, Housing NZ re-emerged as a major provider of purpose built rental accommodation in Auckland.

On the heel of the above examples, the rental housing supply pipeline has evolved to now include early build to rent product. The emergence of dedicated build to rent fund managers has accelerated the stock and supply pipeline and there are now a small handful of active build to rent investors, with more looking to enter the market. These investors range from high net worths with overseas build to rent experience and personal ties to New Zealand, new, exclusively build to rent focused investment/development vehicles, corporates looking to diversify a purely commercial portfolio, and pension funds.

New Zealand build to rent stock is being provided in two main ways; either through the bulk purchase of off plan new dwellings (in some cases in projects that are struggling to achieve sufficient presales in the current



market environment), or as a purpose built new build. These new build units can be entirely build to rent developments, or be integrated with traditional build to sell units. In some developments, leasing has been guaranteed by employers looking to help staff secure accommodation.

One of the major challenges for build to rent in New Zealand is finance. In the US, preferential mortgage markets exist where higher LTV and lower interest rate pricing is available. New Zealand banks are aware that build to rent is emerging but as an unproven and untested sector caution prevails, preventing the favourable lending terms that exist in proven markets.

On the design side there are challenges facing local architects, most of whom have never had experience designing buildings for long term rental purposes. Changes to common areas and building finishes as well as material differences in how living spaces will be used may not be well understood. In mature US markets, premium rents can be achieved even where unit sizes are comparatively small. To improve livability, these buildings include extensive amenity and large, high spec common areas. This trend is driven by occupiers who value living in a full-service building and are willing to trade off dwelling size to access it.

Given the factors underpinning occupier demand and what, from some aspects, is a compelling investment rationale, we do expect build to rent to become a growth sector in New Zealand, however it is clear that there are multiple issues that need to be resolved in order to achieve this.

NEW ZEALAND RESEARCH

Zoltan Moricz
Head of Research, New Zealand
+64 9 359 5399
zoltan.moricz@cbre.co.nz

Tamba Carleton
Senior Research Analyst
+64 9 359 5414
tamba.carleton@cbre.co.nz

FOR MORE INFORMATION REGARDING GLOBAL RESEARCH, PLEASE CONTACT:

Richard Barkham, Ph.D., MRICS
Global Chief Economist and
Head of Global Thought Leadership
richard.barkham@cbre.com

Neil Blake, Ph.D.
Global Head of Forecasting
neil.blake@cbre.com

Henry Chin, Ph.D.
Head of Research, APAC/EMEA
henry.chin@cbre.com.hk

Spencer Levy
Chairman of Americas Research
spencer.levy@cbre.com

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