Build-To-Rent in Australia: The Growth Opportunity

September 2024

IN A NUTSHELL

— The Australian Build-To-Rent market currently sits at an inflection point, mirroring growth experienced in UK over the past decade.
— Rental demand expected to be driven by declining purchase affordability and overseas migration.
— Imbalance between supply and demand should see above average rental growth.
— Supportive government legislation (proposed) likely to see increased capital flows into the Build-To-Rent sector.

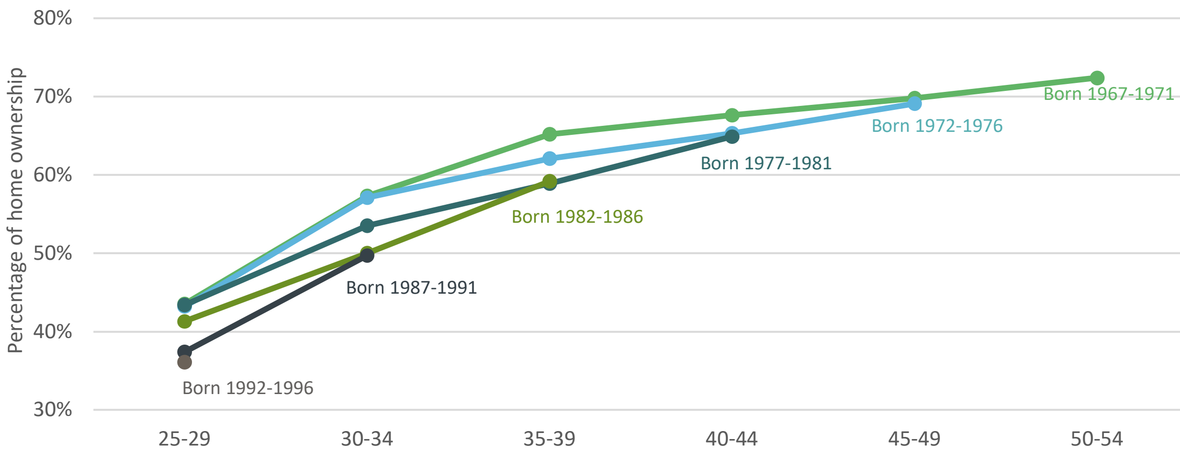
The composition of the Australian residential market creates a unique opportunity to build scale within the Build-To-Rent (BTR) sector. There is an estimated 11 million dwelling within the residential market[1], 70% are classified as houses, 16% apartments and 13% a mix of Semi-detached, Terrace and Town houses[2]. This is very different to markets such as Japan where apartments account for a larger portion of total stock. In Australia, the rental market is largely held by private retail investors with institutional BTR reflecting 0.2% of the total rental supply [3]. Globally, rental markets such as the UK have seen institutional BTR penetration rates increase from 0.1% to 2.0% over the past decade[4], demonstrating a significant growth opportunity for the Australian market.

In Australia, institutional BTR is charactered by apartment style product, with typically between 100-500 tenancies per asset. We believe BTR has numerous competitive advantages over the private rental market. In the private market, apartment rentals typically start off as Build-To-Sell developments, let by a private landlord and managed through a strata committee. For the tenant there is an element of uncertainty with duration of occupancy and maintenance of the property largely up to the discretion of the landlord. BTR assets provide an institutionally managed product for the sole purpose of long-term tenure. Assets are designed through a 'customer centric' approach which typically see a greater degree of amenity such as co-working spaces, gyms, and other communal facilities. Increased amenity, professional management and overall tenancy security generally warrant a rental premium of 10-15% compared to the private rental market.[5]

[1] Housing market update CoreLogic June 24
[2] Housing Census as of 2021
[3] Franklin Street as of September 24
[4] Office for National Statistics UK as of 2022 & UK BTR Market Update Savills as of Q2 2024
[5] DWS Research as of September 24

Diminishing purchase affordability continues to drive demand for rental dwellings. In Australia around a third of the population are renters with an over-representation of people under 44 years of age. People under the age of 44 account for 62% of the working age population yet more than half rent their place of residence[6]. It is evident that the Australian residential market has undergone a gradual but structural change over the past decade with not only a decline in the rate of home ownership, but also time taken to purchase a property (Exhibit 1). A re-acceleration in dwelling value growth experienced over the past 5 years has led to further pressure on borrowing capacity, down payments, and servicing costs. Today the average age of a first home buyer is closer to 40 years of age[7], in turn supporting demand for rental product.

Exhibit 1: Home Ownership Rate by Birth Cohort and Age Group



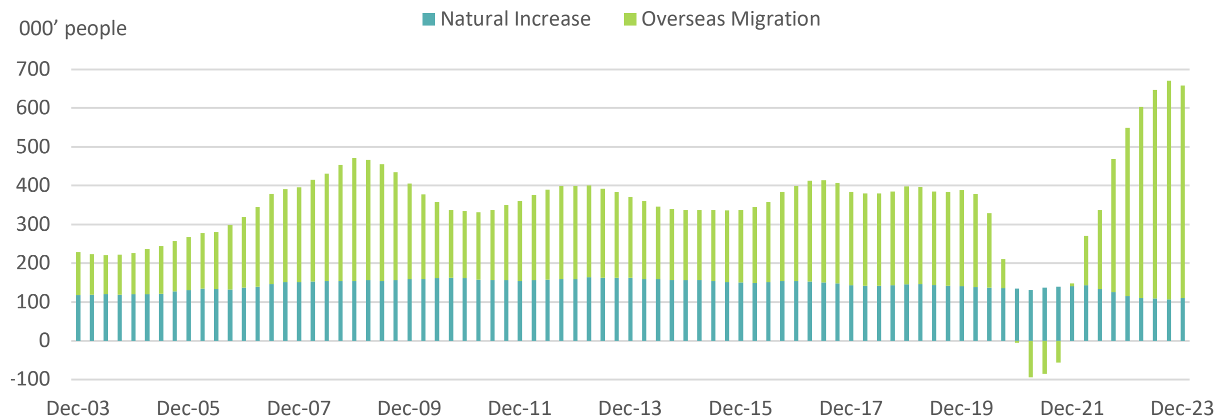
Source: AIHW Home Ownership and Housing Tenure, DWS. As of July 2024 (latest figures as at 2021 census)

Overseas migration is an important source of demand for the Australian rental market. When looking at the composition of Australia's population growth around 50-60% comes from overseas migration (Exhibit 2), buoyed by international students and migrant workers. While international students are typically catered for by university accommodation, migrant workers generally enter the broader residential market. The Federal Government is focused on growing the number of 'skilled' migrant workers within Australia to address short/long term labour needs as well as offset Australia's ageing population. Permanent skilled migration planning levels have increased from 79,600 in 2020-21 to 132,200 for 2024-25[8] with an extension of temporary skilled workings visas for areas of skill shortages.

BTR product is well suited to skilled workers. Firstly, skilled workers generally have a higher propensity to rent with a focus on locations close to employment catchments and transport nodes, which align with BTR locational strategies. Secondly, skilled workers typically enter Australia with very little established social networks. The addition of shared outdoor/dining spaces and recreational facilities found within BTR assets, can assist in stimulating social interactions. Lastly, skilled workers typically work in well paid highly specialised professions, allowing the ability to afford a premium rental product. Continued government support for permanent and temporary skilled worker pathways should therefore see a healthy level of inflows looking forward.

[6] Housing Census as of 2021
[7] SOHO as of January 2024
[8] Department of Home Affairs 2024-25 permanent Migration Program

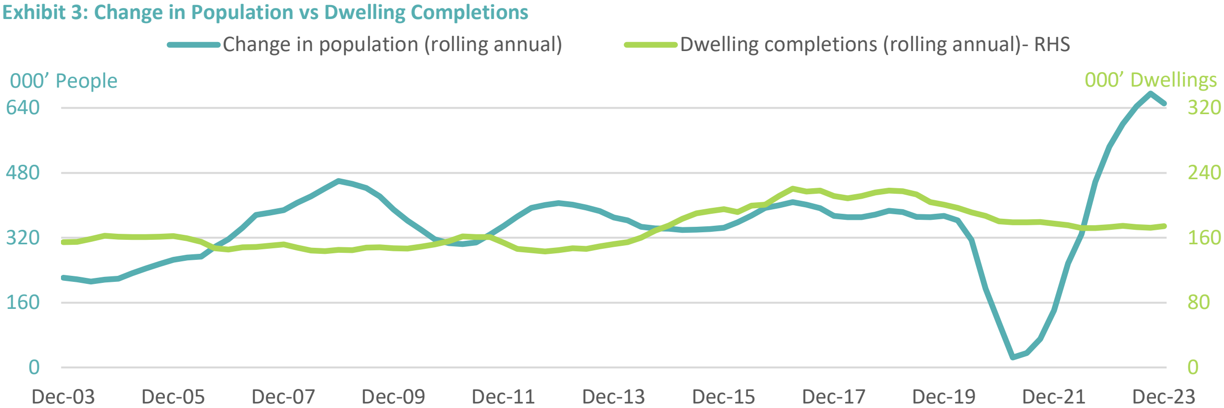
Exhibit 2: Components of Australia's Population Growth



Source: ABS, DWS. As of September 2024

Australia's residential market is experiencing a significant imbalance between supply and demand. Historically residential dwelling completions have averaged 175,000 per annum while population has increased by around 365,000 per annum (Exhibit 3), implying a provision rate of one dwelling for every two people added. The construction industry has been challenged over the past couple of years due to rising input costs, labour shortages and numerous bankruptcies, resulting in subdued dwelling completions. A rebound in net overseas migration against lower dwelling completions has led to a material decline in the availability of rental stock, and a fall in the rental vacancy rate to 1%.[9] Population growth is expected to moderate over the coming years, however a significant supply deficit could remain for many years to come.

Exhibit 3: Change in Population vs Dwelling Completions

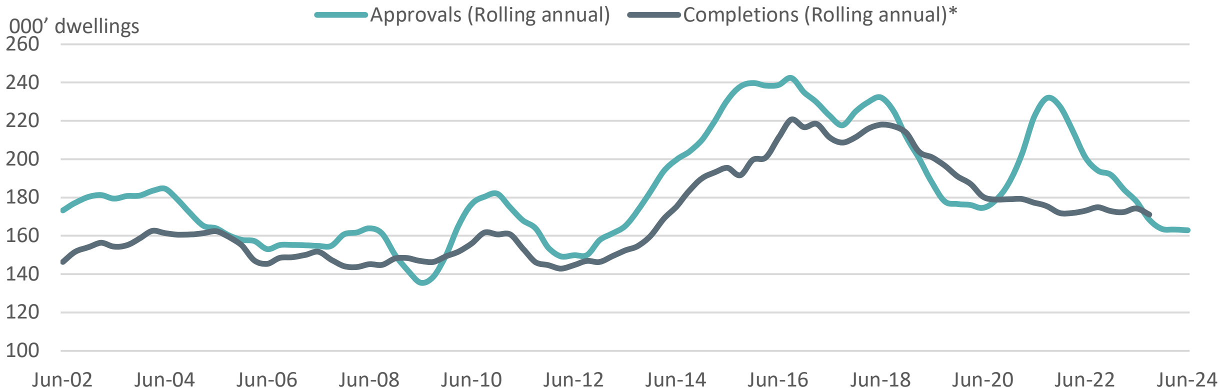


Source: ABS, DWS. As of December 2023

Vacancy is likely to remain low despite ambitious housing targets. To address Australia's housing shortage, the Federal Government has set a target of 1.2 million (240,000 p.a.) homes over the next 5 years including a mix of build to rent, build to sell and social/affordable housing.[10] While these housing targets are aimed at bringing the market back to equilibrium, the ability to deliver remains challenged. To achieve these housing targets the construction industry will need to produce the highest level of home building activity recorded over the past 20 years against a backdrop of capacity constraints. Dwelling approvals, a leading indicator of construction activity remain at a decade low (Exhibit 4), with weakness more pronounced in the apartment sector. Current estimates point to a shortfall of around 260,000 dwellings by 2029[11], which is likely to see rental vacancy remain below historical levels.

[9] Haver/SQM Research as of September 2024
[10] National Housing Accord as of 2024
[11] Oxford economics as of July 2024

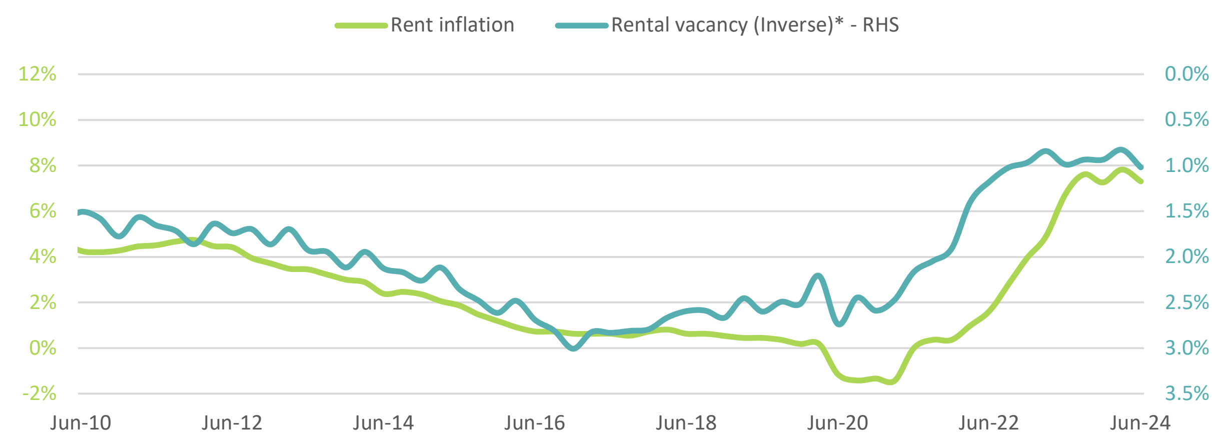
Exhibit 4: Dwelling Approvals vs Completions



Source: ABS, DWS. As of September 2024, *Completions reflect a 2-quarter lag

Periods of lower vacancy have supported rental growth. Historically, the national rental vacancy rate has hovered between 2-2.5%, while rent inflation has average 3.0% (Exhibit 5). During times where the rental vacancy rate has fallen below 2% this is considered a 'landlords market' where rent growth has exceeded the long run average. The rental vacancy rate currently sits below 2% across all capital cities, tightest in Perth and Adelaide. Apartment rental growth has outpaced that of houses over the past 5 years, with the largest increases coming from the lower end of the market. DWS research expects city wide apartment rents in Sydney and Melbourne to grow by 6.5-7% per annum over the next 5 years.[12]

Exhibit 5: Rent Inflation vs Rental Vacancy

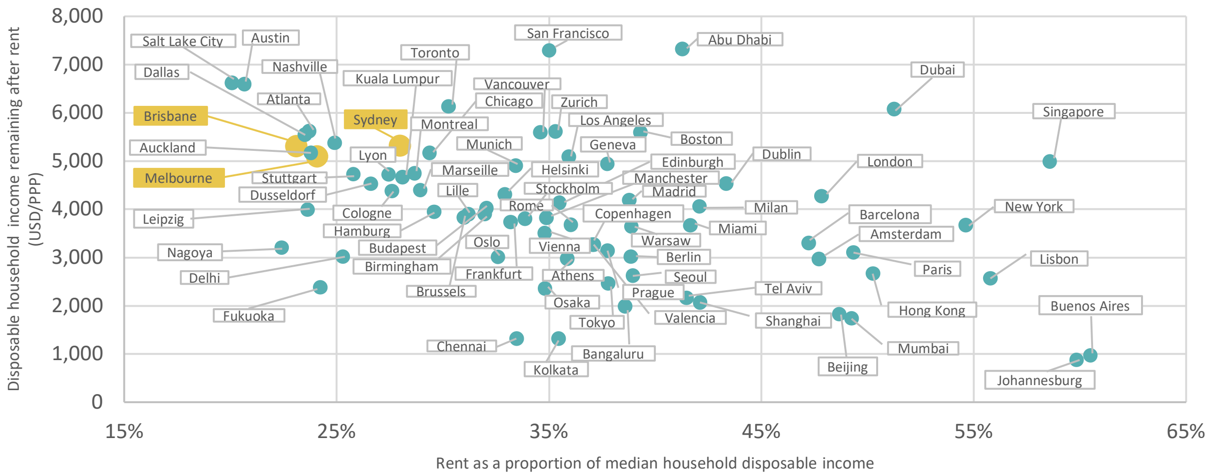


Source: Haver as of June 2024, ABS as of June 2024, *Capital city average

Global comparisons show that there may be upside to the rental growth story in Australia. While the cost of living within Australia is quite expensive, incomes are relatively high compared the OECD average, with minimum wages amongst the highest in the world. There is no single definition of 'rental affordability' however a good place to start is with rental payments as a proportion of median household disposable income. In Australia, apartment rental growth has significantly outpaced that of wage growth over the past 5 years, which has seen median affordability rates weaken from the mid 20% range to closer to 30%, less pronounced amongst the upper quartile income bracket. While affordability rates have weakened, it is evident that Australian cities such as Sydney, Melbourne and Brisbane remain more favorable compared to London, New York, and Tokyo reflecting 40-50% of median household disposable income (Exhibit 6).

[12] Please refer to DWS Asia Pacific Real Estate Strategic Outlook Mid-Year 2024

Exhibit 6: Global Rental Affordability



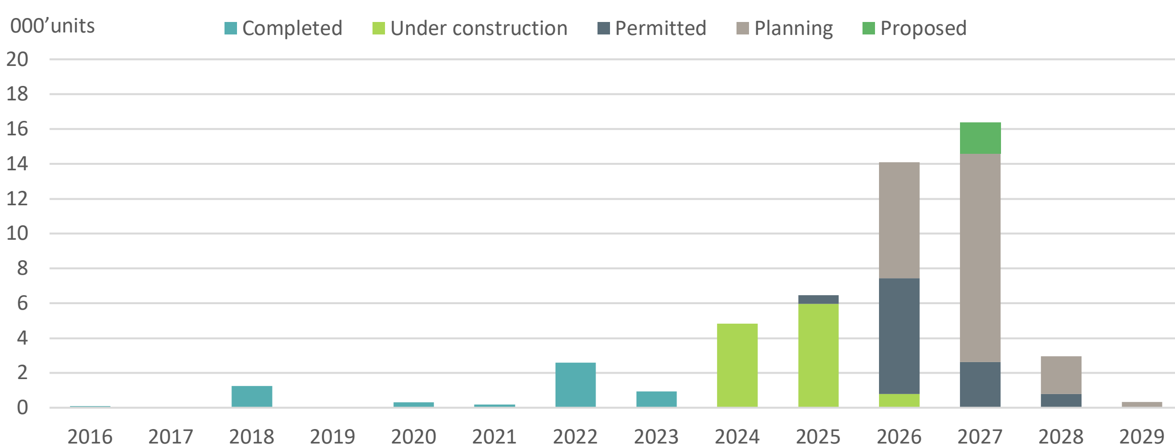
Source: Global Rental Affordability Report DWS Research as of September 2024 * Analysis reflects two-bedroom units.

The BTR pipeline is within its early stages of growth, which provides opportunity for institutional investment. In Australia there is a total of 5,398 operational build to rent units across 20 assets.[13] Most of the current assets are concentrated within the Melbourne and Brisbane markets within 5kms of the CBD, typically where the highest rents were achieved.

The BTR supply pipeline currently sits at 46,549 units across 124 projects (Exhibit 7), however only a quarter of this is under construction with the balance reliant on planning approval and funding. While it is evident that most of the future supply is forecast in Melbourne, the market is seeing a diversification of geography with a growing number of projects in Sydney.

Developments are also becoming less focused on CBD adjacent suburbs, with an emphasis on well-located sites along key transport nodes. This is evident in the Sydney market where the introduction of the 'Sydney Metro' train line has halved commuter travel times into the CBD benefiting locations such as Macquarie Park, Chatswood, North Ryde, and North Sydney. With the estimated completion value of the national BTR pipeline around $39 billion this provides substantial liquidity for investment markets.

Exhibit 7: National Build-To-Rent Supply Pipeline



Source: Franklin St as of September 2024, DWS Research as of September 2024

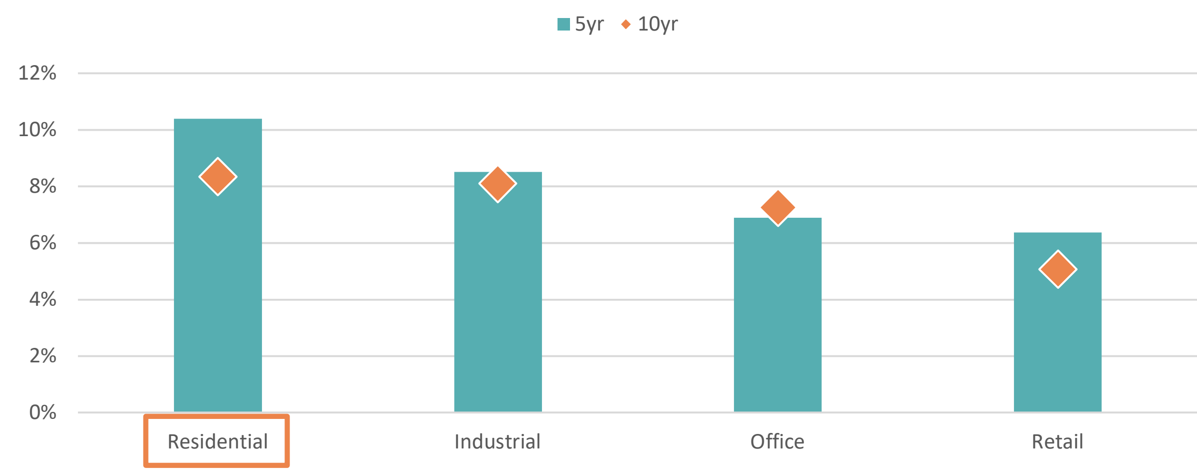
[13] Franklin Street as of September 2024

Supportive government legislation is likely to see increased capital allocation to the BTR sector. Traditionally, investment into global BTR markets has come from large scale pension and insurance funds who are attracted to the long term, low volatility inflation linked income streams of the residential sector. The tightly held nature of the residential market in Australia has seen initial yields remain relatively low between 4-5% compared to that of office and industrial, which places greater emphasis on income returns to drive IRR's.

For foreign investment, tax concessions are an important part of investment feasibilities which to date have hindered capital flows into the Australian BTR market. The Federal Government has recently proposed a bill for enhanced tax concessions for BTR developments, however yet to be formally legislated. The first proposal is a reduction in the MIT withholding tax rate on foreign managed investment trust payments (distribution of rental income and capital gains) from 30% to 15%, which will move the BTR sector more in-line with traditional property sectors. The second proposal is an increase in the capital works deduction rate from 2.5% to 4% per year reducing tax leakage in the cashflow.[14]

Supportive legislation coupled with a strong rental growth outlook could potentially lead to attractive investment returns in our opinion. DWS forecasts total returns for the residential sector to be above 10% over the next 5 years. (Exhibit 8)

Exhibit 8: Australian Total Return Forecasts (2024-2033) - Unlevered



Source: DWS Asia Pacific Real Estate Strategic Outlook Mid-Year 2024, Forecasts are not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

[14] Treasury Laws Amendment (Build to Rent) Bill 2024 and Capital Works (Build to Rent Misuse Tax) Bill 2024 (provisions) as of 2024

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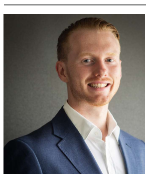

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