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Outlook investment trends

Future investment models such as build to rent and capital flows.

Although often used synonymously in the media, it is important to make the distinction between 'build to rent' and 'affordable housing', as build to rent can include a range of product types at different price points, but does not necessarily relate to low-cost/government-subsidised rental housing.

Build to rent

'Build-to-Rent' or 'Multifamily' as it is known in the US, is the terminology used to describe institutional rental accommodation where the whole development is owned and operated by developers or groups of investors.

Despite being relatively new to Australia, the concept of build-to-rent is well established globally; measuring $A319bn in total, of which $A106bn is in the United States. For the 11 markets where MSCI measures residential real estate, annualised income returns range from 3.3% (UK) to 5.7% (Canada) over the past 14 years, with the US sitting in the top half of the pack, averaging 5.2%.[2]

Research suggests similar yields could be achieved in the Australian market, making the sector increasingly attractive to investors as domestic commercial yields continue to compress to comparable levels.

The lower yields on residential build-to-rent by comparison to commercial assets, have generally being offset by a strong capital growth profile and diversification of risk across the property lifecycle.

Residential build to rent has typically become prevalent in markets with falling affordability, higher population growth and constrained supply – all factors which are applicable to the current Australian property climate.

2. Property Council of Australia and MSCI - Australian Property Still Performing Strongly, while Build-to-rent has Proven itself Globally

https://www.propertycouncil.com.au/Web/News/Articles/News_listing/Web/Content/Media_Release/National/2017/Australian_property_still_performing_strongly__build-to-rent_has_proven_itself_globally.aspx

However, domestically there are a number of government policies and taxes which make the build to rent model prohibitive. In the traditional build-to-sell model, GST is recouped at the time the product is sold, whereas this mechanism does not exist for build to rent. Land tax can also be a financial barrier, where the total land value of the development is attributed to one owner, rather than distributed across multiple owners in a strata scheme, and is therefore more likely to exceed the land tax threshold.

That said however, with its demonstrated success overseas, the build-to-rent model is beginning to gain momentum in Australia. This is driven in part by interest from offshore capital sources, which are generally more familiar with the concept.

The popularity of the sector will largely depend on whether commercial yields continue to compress to residential levels and whether build to rent will remain a competitive alternative. With the RBA cash rate remaining at a historic low of 1.5% and Deloitte Access Economics anticipating the cash rate will be on hold until well into 2018, the outlook does looks positive.

Capital flows

Foreign capital continues to play a key role in driving Australia's economic growth. The latest Australia Bureau of Statistics data highlights the total level of foreign investment in Australia (including real estate and non-real estate sectors) increased by $153.3bn (5%) to reach $3,192.4bn for the year ended 31 December 2016. Overall the United States continues be the biggest source of foreign investment at $860.9bn, representing 27% of the total foreign investment market (Chart 1).

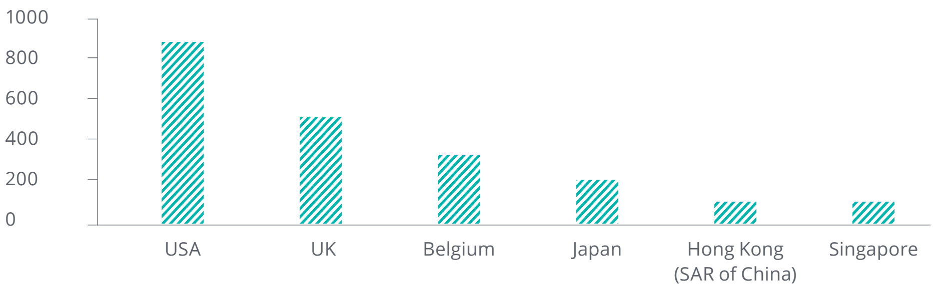
For the third consecutive year China represents the lion's share of foreign real estate approvals, by both value and number. Investment from China represents 26% of the total value of approvals and a growth of 31% since 2014-2015,[3] according to the Foreign Investment Review Board (FIRB).

It is important to note that FIRB approvals data does have significant limitations, the most important being that approvals do not represent actual purchases, but rather provide an indication of the planned future investment. As much of the FIRB data is measured by value, significant one-off proposed transactions can distort the figures.

Foreign nationals are not permitted to buy an established residential dwelling in Australia, however they are allowed to purchase off the plan or newly constructed buildings and rent, sell or live in them.

This means that foreign investors are more active in certain sectors of the residential property market, for instance large scale apartment developments, which are concentrated predominately in inner Melbourne and Sydney and to a lesser extent, Brisbane.

Chart 1 – The billion dollar levels, by leading countries, of the total foreign investment in Australia for year end 31 December 2016



Source: ABS

According to the ABS, the leading investor countries for the year ended 31 December 2016 were:

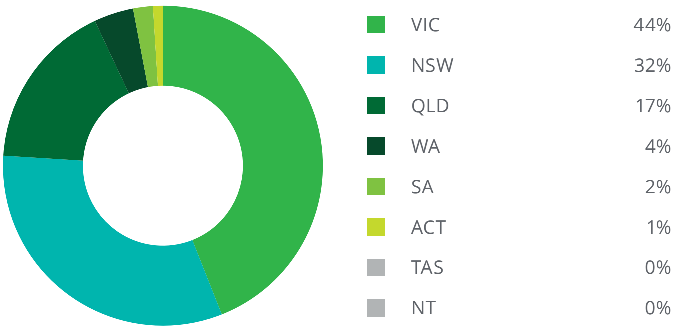
- **United States of America $860.9b (27%)**
- **United Kingdom $515.5b (16%)**
- **Belgium $270.1b (9%)**
- **Japan $213.5b (7%)**
- **Hong Kong (SAR of China) $100.9b (3%)**
- **Singapore $98.9b (3%).**

3. FIRB Annual Report 2015-2016 (for the year ending June 2016)

Victoria has the market share of foreign investment at a state level, representing 44% of the total number of foreign investment real estate approvals (Chart 2).

The FIRB's report notes that three-quarters of all residential real estate approvals were for purchases in Victoria and New South Wales. This is consistent with recent years and reflects strong demand for residential property in Sydney and Melbourne.

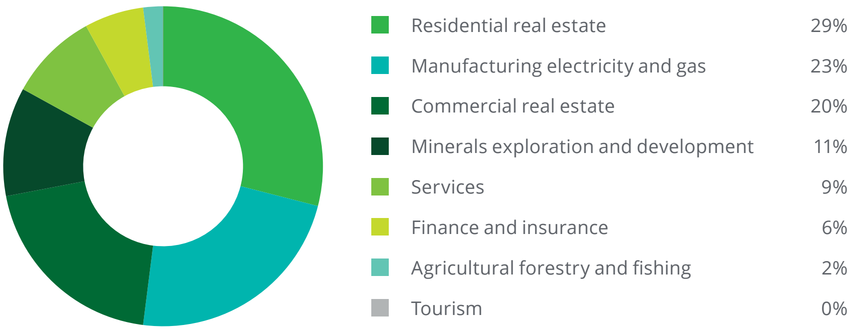
Chart 2 – Number of approvals by state and territory



Source: FIRB

The residential real estate sector represented the largest share of foreign investment value (29%) for the financial year ending June 2016, according to FIRB data (Chart 3)

Chart 3 – Share of total approvals by industry sector in 2015-16, by value



Note: Totals may not add due to rounding, Corporate reorganisations are excluded (99 in 2015-16 Source: FIRB)

Australia's appeal

Australia's supportive macro-economic environment and robust real estate fundamentals are attractive to foreign investors chasing yield and the opportunity to fill a local credit market gap.

Banks dominate the Australian real estate development debt market. However, they are actively reducing their exposure ($216bn) to commercial real estate lending, leaving many developers struggling to obtain alternative funding.

The banks represent more than 90% of the market, mortgage funds are minimal and private debt is inadequate, creating a significant dislocation in the real estate debt market. This gap in the market and lack of competition presents an immediate opportunity for a large pool of capital to capture the growing level of demand for development debt.

Provided the underlying asset class is sound, then the current lending environment is providing abnormally high returns, particularly in a low interest rate environment. The window of opportunity for these returns is anticipated to be 24-36 months, before more normalised capital flows return to the sector.

The most dramatic change in active debt lenders is the mortgage fund sector. The GFC saw the demise for mortgage funds in Australia, which effectively became the 'shadow banking' sector of the debt market. At its peak the mortgage fund sector had FUM of $18 billion. Today the mortgage trust sector is estimated to have FUM $2 billion.

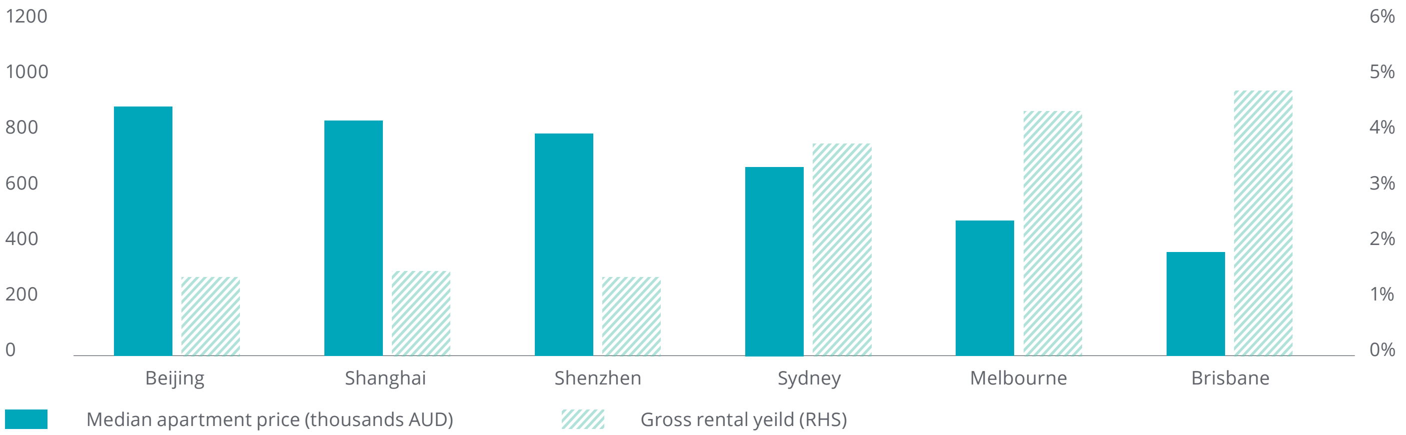
Chart 4 – There has been a dramatic reduction in competition of active real estate debt lenders since the Global Financial Crisis:

Active lenders	Major banks	Regional banks	Mortgage funds	CMBS	Private/family office	Total
2008	4	12	60	4	4	**84**
2016	4	4	6	1	10	**25**

However Australia's mature and comparatively stable financial markets and well-regulated land title system does appeal to foreign investors. Similar markets such as New Zealand and Canada have likewise become havens for global capital in recent years, particularly for Chinese investors.

The regulatory environment, lack of political and economic freedom and conditions in the Chinese economy, make foreign markets particularly attractive to Chinese investors. In 2016, the Chinese currency depreciated nearly 5% against the US dollar, while appreciating against the Australian dollar by nearly 12%. The impact of such currency movements results in Chinese investors reconsidering what and where they can afford to purchase, with the Australian real estate market looking increasingly attractive. Australia's gross rental yields of 4-5% in major cities are twice that of China's major cities (Chart 5).

Chart 5 – Median apartment prices and gross yields – December 2016



Source:Bloomberg, ABS, CASS, Centaline, Domain, Credit Suisse

In China urban land is state owned with a 70 year lease to housing owners. In contrast Australian real estate is mainly freehold. Rural land in China is owned by village collectives with limited competition and as a result low price growth. China also has a 30% deposit requirement on residential real estate purchases (which goes up even further for buyers looking to purchase a second property), compared to 10% in Australia.[4]

Housing acquisitions in Australia by Chinese investors are typically below the US$5 million limit and therefore the restrictions on capital outflows introduced by the Chinese government may not have a large impact for Australia.[5]

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4. Deloitte Access Economics - Juwai.com, 8 May 2017. Here's why domestic restrictions are driving Chinese buyers abroad. Available at: https://list.juwai.com/news/2017/05/heres-why-domestic-restrictions-are-driving-chinese-buyers-abroad

5. Deloitte Access Economics - Altmann, E. & Yang, Z., 2 May 2017. Why Chinese investors find Australian real estate so alluring. Australian Broadcasting Corporation (ABC). Available at: http://www.abc.net.au/news/2017-05-02/why-chinese-investors-find-australian-real-estate-so-alluring/8489686

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