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Set to arrive.

The rise of the Australian multifamily sector | White paper

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The Australian multifamily sector is poised to emerge, underpinned by compelling top-down fundamentals. The experiences of other markets offer many learning points and astute investors can navigate and succeed in this new asset class.

Compelling fundamentals to drive momentum in Australian multifamily

The emergence of the multifamily sector in Australia is much awaited by investors and end users. We identify structural factors catalyzing the development of this sector, as well as the challenges that investors may face. We set out a few approaches that could be appropriate for investors with varied investment objectives.

Poised to emerge

Even as investors continue to seek refuge from the carnage brought about COVID-19, the global multifamily segment has displayed tremendous grit. We can all agree that having a roof over our head is a necessity, pandemic or otherwise. What COVID-19 really did was highlight the resilience and non-discretionary nature of the residential rental sector globally, underscored by generally stable rent collections and relatively limited delinquency. Arguably, Asia Pacific (APAC) is behind the curve in terms of the maturity of the multifamily sector. The single largest and developed APAC multifamily market is Japan, which was in fact very fragmented as recently as a few years ago. That has since changed as institutional investors have warmed up to its potential and piled into the market.

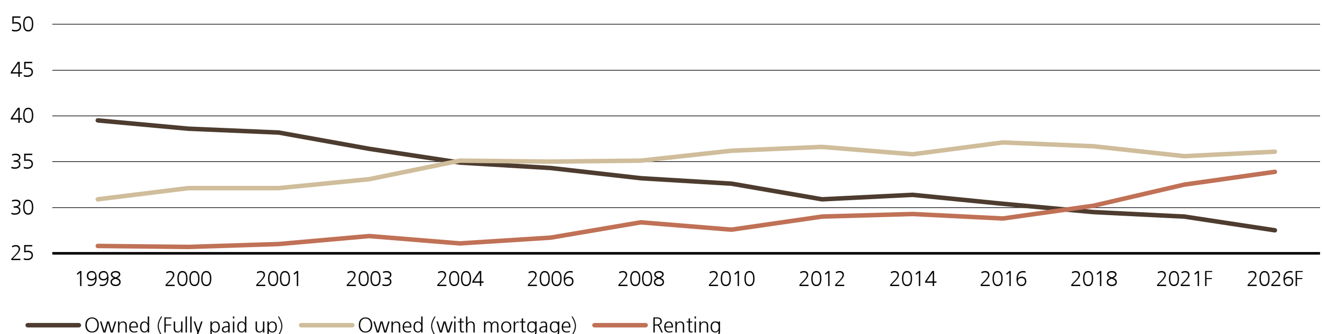
Casting our horizons across APAC, we believe the Australian multifamily sector is poised to emerge next. The trajectory in other markets suggests that this process will not be linear, but the headroom for growth could potentially reap strong dividends for early movers.

Generation Rent becoming a reality

Home ownership has always been popular in Australia, to say the least. A poll conducted by the Australia National University[1] in 2017 showed that almost three-quarters of Australians regard home ownership as integral to the *Australian way of life*. However, almost 70% also expressed concerns at potentially falling short of this home ownership aspiration. To that end, Generation Rent is fast becoming a reality, whether by chance or by choice. In 2018, the proportion of renting households was almost equal to that of households which own their dwellings (see Figure 1) and that is expected to increase. We will delve deeper into the structural drivers behind this phenomenon.

[1] 24th ANUPoll – Attitudes to Housing Affordability: Pressures, Problems and Solutions, published in 2017

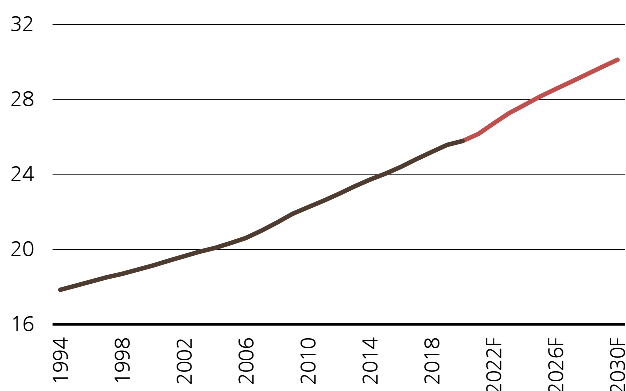
Figure 1: Percentage of households by dwelling status (%)



Source: Australia Bureau of Statistics (ABS) Housing Occupancy and Costs (2017-2018), Knight Frank (Tenant & Investor Survey 2018), UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

Population growth drives accommodation demand
Australia ranks among the few developed economies globally that will experience positive population growth in the next decade at least. Its resident population is expected to breach the 30 million mark by the year 2030, an increase of approximately 65% from 1995 levels (Figure 2). To put this into perspective, that is equivalent to almost adding another Belgium, or approximately two Hong Kongs to the population.

Figure 2: Estimated resident population (million)



Source: Australian Bureau of Statistics, Oxford Economics (as at January 2021), UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

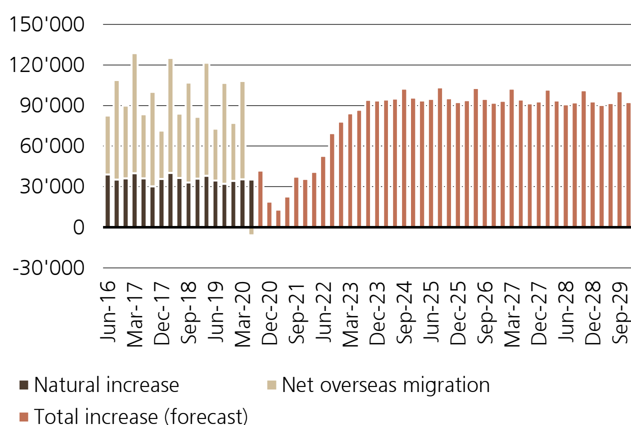
Much like countries such as Luxembourg and Canada, the population growth in Australia has been primarily driven by immigration (see Figure 3). That has helped Australia maintain its competitiveness in the global market, boosting productivity and domestic consumption, allowing the country to enjoy sustained demographic dividends.

Clearly, the closure of borders and the uncertainty around the pandemic have led to an unprecedented slowdown in population growth in 2020. In fact, inward migration recorded a net negative in some quarters last year, as some migrants returned to their home countries. In our view, that is an exception rather than the norm. However, we do expect to see population inflows resuming gradually by 2023, and continuing on a stable trajectory.

Market watchers have commented on the possibility of policymakers in Australia succumbing to popular pressure to roll back existing immigration policies that are deemed too liberal. This comes on the tail of simmering sentiments arising from wage stagnation and surging home prices – what many believe to be caused by the influx of new residents. While there could eventually be a more selective process towards immigration in the near future, it is not in Australia's favor to reverse course entirely, and drastically. As such, population growth will continue to feature strongly in the Australian economy.

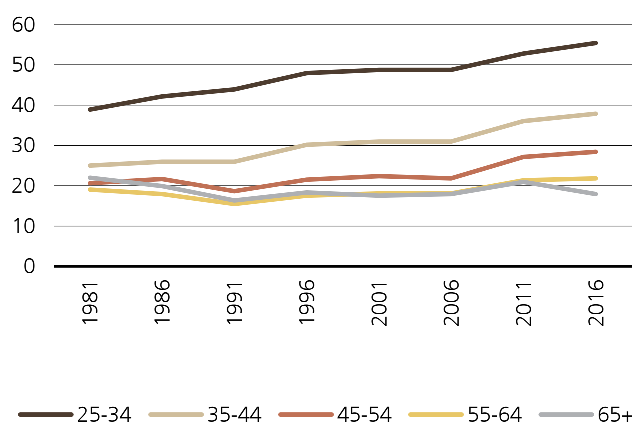
The ongoing increase in the number of residents brings about a structural rise in the demand for accommodation. Moreover, it is expected that the working-age cohort will make up a huge proportion of the total projected population increase in the next decade. Specifically, new residents aged 15-44 years will comprise almost 40% of the incremental population in Australia by 2030. This is the age bracket in which working adults start to embark on family formation. In 2016, during which the last census was conducted, more than 50% of Australian residents within the 25-44 year age group were renting their homes. Similarly, more than 35% of people in the 35-44 bracket were renters. As such, the fundamental demand for multifamily will be supported by population growth and a core group of potential renters.

Figure 3: Net population growth (quarterly)



Source: Australian Bureau of Statistics, Oxford Economics (as at January 2021), UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

Figure 4: Historical share of renters by age group (%)



Source: Australian Bureau of Statistics, UBS Securities Australia Ltd (September 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

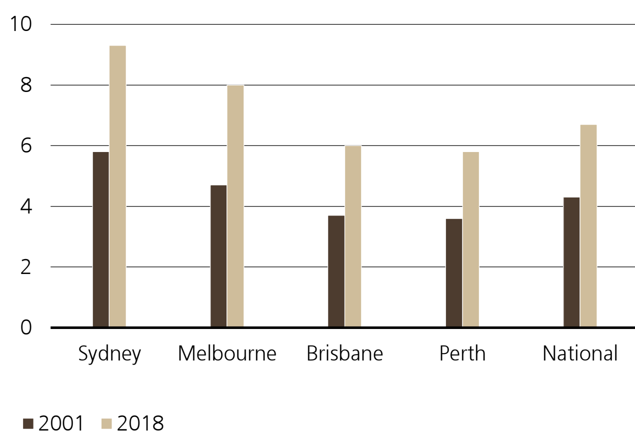
Worsening home affordability boosting the renter pool
The rise in home prices has exceeded income growth in many key Australian cities, and this worsening affordability has indirectly steered potential homebuyers into the private rental market. According to analysis by CoreLogic, national home price to income ratio was 4.3x in 2001 and that multiple deteriorated to 6.7 times in 2018 (see Figure 5). In key cities such as Sydney and Melbourne, the worsening affordability was more acute, elbowing many aspiring homeowners out of the sales market. The corollary of worsening home affordability in Australia is the increase in propensity to rent, as manifested in the emergence of the Generation Rent (Figure 1).

There are several explanations to this phenomenon, chief of which is the centralization of migrants into capital cities where more jobs are available, indirectly pushing up home prices. Also, from the income perspective, the global economy and Australia saw very lethargic wage growth for a long time even as asset prices surged ahead.

A significant proportion of homebuyers are first time buyers and would not have already profited from gains through prior property transactions. In fact, data from the ABS Survey of Income and Housing shows that roughly half of home buyers in the 25-34 years age group are first time buyers. Similarly, 28% of home buyers in the 35-44 years age group are new homeowners. Again, this corroborates with our earlier point that there is a high ratio of renters in the cohorts which comprise the family formation age groups.

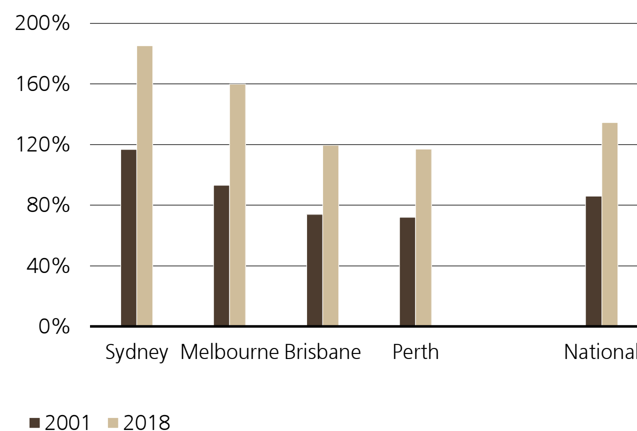
Furthermore, the process of securing a housing loan is not as simple as plainly assessing the mortgage servicing ability. Borrowers must put up a deposit before any bank grants them a housing loan. This is a key deterrent to many home buyers, which pushes them to the sidelines. In 2001, a typical household needed to set aside 86% of its annual household income as a deposit to qualify for a home loan, but that figure jumped to 134% in 2018 (see Figure 6). The same household would have to set aside 185% and 160% of its 2018 annual income as deposits in Sydney and Melbourne, respectively. Arguably, this multiple is higher today than in 2018.

Figure 5: Home price to income ratio (multiple)



Source: Aussie-CoreLogic 25 Years of Housing Trends (2019), UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

Figure 6: Percentage of annual household income required for a 20% home loan deposit (%)



Source: Aussie-CoreLogic 25 Years of Housing Trends (2019), UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

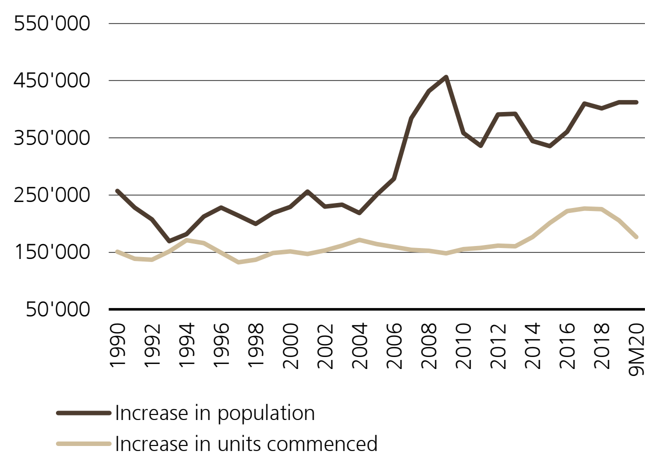
While home price to income is a good benchmark of affordability, the interest rate environment in Australia has notably turned more accommodative in the past few years. The government has also been forthcoming in financial measures to encourage and support first time home buyers. It is fair to assume that the associated costs with servicing a mortgage is lower today than it was a few years ago. All in, it gives the appearance that homebuyers should find it easier to enter the market, instead of having to rent. That is only partially true.

To that end, the multifamily sector can provide an interim and scalable solution for many who are unable to cross the total home affordability hurdle. It need not necessarily displace the home ownership aspirations totally. In fact, the Australian multifamily sector can potentially allow future homebuyers to set up their family units while accumulating their financial resources in a more cost-rational manner.

Chronic undersupply of housing has no silver bullet
While the demand for housing grew in tandem with the increase in population, the supply of accommodation in Australia did not manage to keep pace over the years. This buildup in the undersupply situation has longer-term implications. Besides the fact that home price increases were partly a function of this undersupply, what is also worrying is the deep social-economic divide arising from the deficit of housing options for the masses.

Under-building in the residential sector became severe in the ensuing years after the Global Financial Crisis (GFC) even as interest rates were trending down. Housing commencements across Australia picked up only after 2013, almost doubling the annual average in the past two decades (see Figure 7). That was driven by population growth as well as a surge in investment interest from domestic and overseas investors.

Figure 7: Change in population, and dwelling units commenced (3-yr moving avg.)



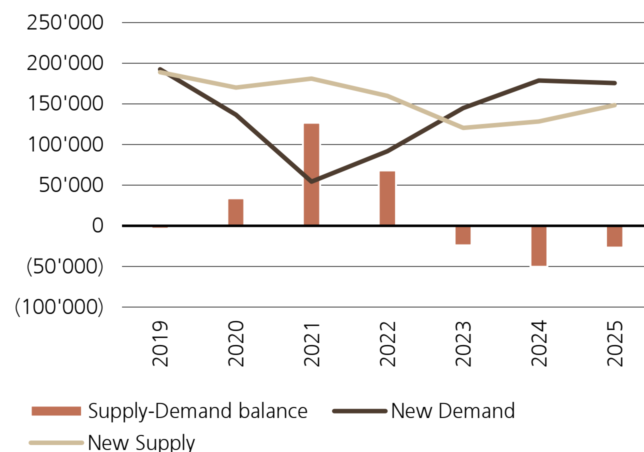
Source: Australia Bureau of Statistics, UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

The latter came to a head towards 2018, as tighter rules on investment financing kicked in, and that put the brakes on the pace of housing starts. This feast and famine cycle in housing supply averaged out to a long-term shortfall in housing vis-a-via real occupier demand.

One could argue that the pandemic has ironically closed up the housing deficit, as overall housing demand retreated in 2020. Moreover, population growth has pulled back and could remain low for a while, which buys time for housing supply to catch up. That said, the underlying problem is the long time accumulation of the housing undersupply which is a chronic issue. Even if the annual housing supply-demand balance turns net positive (i.e. supply exceeds demand) in the next few years, that would immediately revert to a net negative once the population inflows return (see Figure 8). We need to bear in mind that new supply is not as reactive as new demand, and that the approval and construction cycles require time to respond.

This pent-up demand for accommodation was layered on over many years, of which the construction of new housing is now struggling to close the gap. In December 2020, the National Housing and Investment Corporation suggested that nationwide housebuilding output would need to be maintained at similar levels for many years before the previously accumulated supply deficit can be balanced out. Given that there is no silver bullet to Australia's housing shortfall, it is understandable that various state governments are evaluating the potential of the multifamily sector to supplement the supply of accommodation.

Figure 8: Australia housing supply and demand (units)



Source: National Housing Finance and Investment Corporation (State of the Nation's Housing 2020), UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

Again, this is an urgent and critical factor supporting the development of a buoyant multifamily market in Australia. According to a report by interdisciplinary consulting services firm Urbis in November 2020[1], Australia will have to increase rental dwellings by more than 400,000 units by 2030. The Eastern Seaboard would require a larger delivery of multifamily units given the deeper pool of demand. This provision of multifamily housing in Australia simply expands the list of options for people based on their financial situations and personal aspirations. It complements the broader effort to boost housing supply in the nation, albeit in a scalable and more efficient manner.

[1] Build-to-rent: Stimulating recovery, ensuring resilience (November 2020)

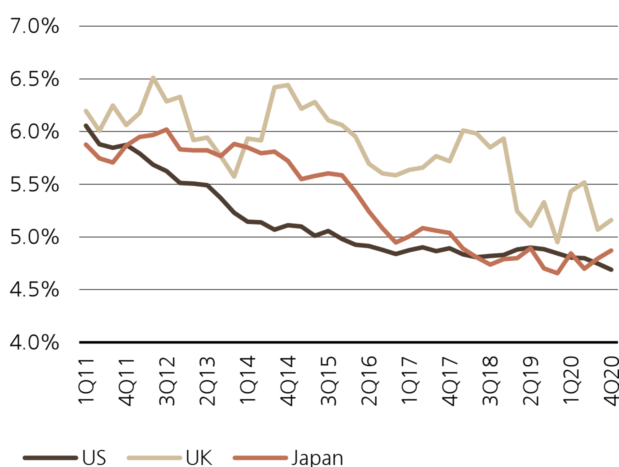
The opportunity

The multifamily sector is considered highly mature and institutionalized in markets such as the US and UK. We are currently seeing the development of the sector in Japan. These markets offer a similar storyline, in that early movers could be well rewarded for their exposure to a nascent sector. We probably saw the same in the logistics sector, which is considered a mainstream investment class these days, but it also took some time to shake off its upstart reputation. So how big an asset class can Australian multifamily become?

We approximate the total investable universe for commercial real estate in Australia to be close to AUD 1.5 trillion, of which a third is institutionally owned. JLL estimates that residential assets make up roughly 5%, 12% and 25% of institutional property portfolios in the UK, Germany and the US, respectively. Taking a conservative approach, a back of the envelope analysis tells us that even at 10% of the total institutional investments, the Australian multifamily sector can potentially be an AUD 50 billion asset class. Based on the latest available census data in 2016, the Australia Bureau of Statistics puts the value of housing stock in Australia at AUD 6.6 trillion. This means that even at AUD 50 billion, the multifamily sector is not even valued at 1% of the Australian housing stock. The potential for scale is hard to ignore.

Being a new sector, Australian multifamily has a very limited capital markets track record, if any. This means that price and yield discovery can only gradually take place over time. Notwithstanding, the experiences of other established multifamily markets can offer very useful references.

Figure 9: Multifamily average cap rate (%)



Source: RCA, UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

Specifically, the early stage of institutionalization presents a significant runway for cap rate compression as multifamily markets mature (see Figure 9). In the post-GFC period from 2010 to 2015, the US multifamily market underwent a renaissance, and we saw cap rates compress by almost 107bps over a five-year period. In the UK and Japan, multifamily cap rates tightened by approximately 100bps and 77bps respectively, during 2015 to 2019. The spread between the office and multifamily sectors also narrowed during the respective peak periods of institutionalization. This infers that the weight of capital was focused on the potential of the multifamily market, which supported capital value growth in excess of the broader market movement.

The fundamental appeal of the multifamily sector lies in its defensive nature and strong income security characteristics. Even so, we are of the view the same capital markets trajectory could happen in the Australian multifamily sector once it is firmly established. The implication is that investors which are able to ride the early part of this cycle may be able make the most out of this limited window of capital value growth while still enjoying the steady income profile of the Australian multifamily segment.

The challenges

The current narrative around the Australian multifamily sector has converged around its economic feasibility, in particular the concerns around the current tax regimes which are punitive towards the sector. There is, to some extent, increasing stigmatization against the actual execution and implementation of a multifamily strategy in Australia at this point in time. Let's be clear here. The unfavorable taxation treatment for a build-to-hold residential product is indeed a key pain point that leads to some leakage in overall returns.

However, we also need to consider the fact that policies are concurrently being reviewed and reworked by some state governments. As we mentioned in the earlier sections, nurturing a multifamily market is very much aligned with the socioeconomic goals of the government. Things are changing and policy tweaks are being introduced in some states.

Without going into too much detail, the key impediments in the Australian multifamily sector are as follows.

Withholding tax for Managed Investment Trusts (MIT): Foreign capital investing into the multifamily sector through MIT structures are taxed at a higher rate (30%) than local investors (15%), or if they were to invest into other commercial real estate sectors (15%). That is because income from residential real estate is denied a lower concessionary tax rate due to fears of speculative and inflationary effects on the wider housing market.

Land tax threshold: For a traditional strata owner of a single residential unit, the value of the asset is often below the land tax threshold imposed by the various state governments. This means that the effective land tax paid is often very minimal, if any. However, from a single ownership perspective, an individual multifamily asset will most likely breach the land tax threshold, subjecting the property to higher tiers of land taxes. This may be further complicated should the beneficial owner be a foreign entity.

Financing constraints: After the Royal Commission into Misconduct in the Banking Sector was concluded, a funding gap has emerged in real estate lending. Major banks are now less enthusiastic about underwriting residential-sector related loans, outside of household mortgages. For an asset class such as build to hold multifamily, it is arguably harder for traditional banks to underwrite construction loans, given that there is no security in the form of pre-sales, unlike a build-to-sell product. Underwriting assumptions will also be largely untested given the dearth of historical credit data and sector performance.

Social components of affordable housing may be imposed: While not the case yet, a clear objective of many state governments is to ensure the equitable and universal access to housing for the people. The Australian multifamily sector may set out to be profit maximizing, tapping on the technical and sector know-how of the private sector developer-operator.

However, there is also a chance that governments may impose conditions on land sales, such as stipulating a certain percentage of a multifamily development to be set aside for affordable housing. From an investment perspective, this may affect the underwriting and returns of multifamily investors, although it could also be compensated through lower land and related costs.

While the above factors appear challenging, the actual execution is important. For one, investors who can source and structure transactions efficiently will still find an angle to generate risk-adjusted returns, that would not necessarily pale in comparison with other markets. Obviously, the devil is in the details and on the ground capabilities play a big role here.

Secondly, it is encouraging to know that some state governments are walking the talk and have already made baby strides towards improving the investment landscape for the multifamily sector. For example, the big states of New South Wales and Victoria have announced changes in stamp duty and land tax regimes that seek to motivate greater participation from the private sector. This is an ongoing process, and we believe more changes could be afoot.

Strategic viewpoints

The opportunity set around the Australian multifamily sector is clear. The challenges are also laid bare. Such is the level of transparency in the Australian real estate market, and this reminds us again why Australia continues to generate considerable investment interest across most sectors. What is complicated for many investors is bridging the gap between the opportunities and challenges in this emerging multifamily sector. We do not offer any prescriptive answers here but set out a few approaches that could be appropriate for different investors with varied investment objectives.

The multifamily sector is fundamentally defined by its resilient and stable income security. Stabilized yields in the multifamily sector are likely to land close to that of the office sector, and that has been corroborated by other multifamily markets globally. What this implies is that a mature Australian multifamily market will ultimately offer sufficient depth and liquidity to the investor, on top of a very stable income profile. Investors may need to adjust their mindset around this *commercial residential* asset class, and rationalize their returns expectations in line with what core property sectors are offering.

A middle of the road strategy would be to embark on conversions and value-add work. Now, this is probably a lot trickier that it looks, as the specifications for a multifamily asset may not necessarily be straightforward. For example, the layout of a hotel or a retail mall is very different from that of an apartment block, and amenities may also not be readily installed if mechanical and engineering structures are fixed. However, at the right entry price, this strategy may be financially viable.

The other extreme end of the risk spectrum throws up the possibility for investors to *manufacture yields* in this sector. That would entail the participation in development with the aim of creating a core multifamily asset or portfolio. Clearly, development brings with it significant risks and investors have to be compensated sufficiently. One way to bring down the overall risks would be to partner with a reliable local developer and partner who can be expected to deliver on the final product.

Alternatively, forward funding may help to mitigate the development risks associated with a greenfield strategy, and that is increasingly a popular option in the Australian real estate sector. The advantage of a development strategy is that it enables the creation of a final product that is relevant and yet future proof. For instance, the prevalence of remote working may lead to multifamily assets incorporating design elements that would make telecommuting conducive. It can also ensure that building specifications are sustainable from the get-go.

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