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How can governments encourage institutional investment to increase the supply of affordable rental housing?

INVESTMENT BY SUPER FUNDS AND OTHER FINANCIAL INSTITUTIONS COULD INCREASE STOCKS OF AFFORDABLE RENTAL HOUSING IN AUSTRALIA. A POLICY FRAMEWORK WILL BE REQUIRED TO DEVELOP A NEW ASSET CLASS THAT MEETS INVESTORS' REQUIREMENTS FOR YIELD, SCALE AND LIQUIDITY.

KEY POINTS

- Large scale investment in rental housing is constrained by low-risk-adjusted yields, lack of a track record, the fragmented nature of investment opportunities and a relative difficulty in quickly turning investments into cash if necessary.
- Constraints can be mitigated by: designing the right investment products; achieving sufficient scale; creating a mix of market value and affordable properties within funds; facilitating a range of different investors; and fostering specialist intermediaries to create diversified portfolios of rental properties.
- A stable policy framework would ensure continuity and a predictable rate of rental return. These factors are essential to convince institutions that the time, effort and setup costs involved in developing a new investment product will be worthwhile.
- The structures and vehicles for investment are likely to be created by the market if the rate of return is adequate, but may need initial government encouragement to become established.

This bulletin is based on research conducted by ***A/Prof Vivienne Milligan****,* ***Dr Ilan Wiesel*** *and* ***Prof Hal Pawson*** *at AHURI Research Centre—the University of New South Wales,* ***Prof Judith Yates*** *at AHURI Research Centre—the University of Sydney, and with* ***Ms Carrie Hamilton*** *at Housing Action Network. The research considered how private financing models can deliver additional supplies of quality, well located rental housing in areas of need that are affordable to low and moderate income households.*

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- Government can create sustainable larger scale investment in rental housing by: establishing the conditions for an initial tranche of investment by institutions; supporting a 'proof of concept' phase to test market preferences and build a track record; providing certainty to investors through a long-term commitment to a targeted incentive payment such as offered by the National Rental Affordability Scheme (NRAS); and supporting the construction of additional affordable housing.

CONTEXT

The significant volumes of public and private finance required to meet the demand for new sources of rental housing (and in particular affordable rental housing) is currently not being met from existing suppliers alone (predominantly small scale investors). The largest potential source of funding is from institutional sources such as superannuation and other managed funds which, crucially, operate with long-term investment horizons.

RESEARCH METHOD

The research was conducted using an investigative panel, supported by interviews with key informants and desktop research. The panel comprised 23 experts from the banking and financial investment sectors, affordable housing providers (for-profit and not-for-profit) and affordable housing industry specialists, together with nominated senior officials from Commonwealth and state government agencies. Panellists met in Sydney on two occasions in late 2012 to discuss their viewpoints and reach their conclusions.

KEY FINDINGS

Factors constraining financial institutions' investment

The panel identified five factors that inhibit institutional investment in rental housing:

1. The poor risk-adjusted rate of return on investment is the biggest issue for institutional investors. Unlike many small scale rental investors, institutional investors heavily discount capital gains and expect higher rental yields than those typically applying in the rental investment market.
2. There is no track record of institutional investment in residential property assets in Australia. Financing new rental supply has been limited to retail investors and to conventional bank finance. There is limited data on the aggregate performance of rental residential assets and uneven knowledge of the operational cash flows of affordable rental housing among funds managers and institutional investors.
3. The fragmented nature of investment opportunities in the rental market has limited scope for aggregation to the scale required for institutional investment.
4. The relative illiquidity of residential property investment—compared to shares and bonds, for example—has discouraged institutional investment. With affordable rental housing, concerns about termination of tenancies (in order to sell assets) reinforce perceptions of illiquidity.
5. Ongoing uncertainty about the long-term future of NRAS threatens the momentum generated by this initiative and investor confidence. Wholesale investors are being held back by the limited value of a tax offset to institutions and the time taken for a decision to be made on applications for NRAS incentives.

Institutional investor interest

There was interest from institutional investors in affordable housing. Financing solutions for both the construction and operating phases of a rental housing supply program need to be considered. The operating (take-out) phase is more likely to attract institutional investment currently.

Government commitment to a viable affordable housing system is crucial to ensure investor confidence in this market. A stable policy framework that generates continuity (including a pipeline of projects at a consistent level) and a predictable rate of rental return will be essential to convince institutions that the time, effort and setup costs involved in developing a new investment product will be worthwhile.

Mitigating constraints

The panel identified five key strategic directions to overcome barriers and attract large-scale institutional investment into the supply of additional rental housing:

1. Design the right product—institutional buy–in to rental housing is most likely to succeed if the investment product is characterised as an 'infrastructure–style' investment offering a steady, predictable cash flow from rental revenue.
2. Achieve sufficient scale—the scale of investment required to attract institutional players is between $50 million and $250 million for an individual institution and at least $500 million per annum in aggregate to create liquidity and establish a sustainable market.
3. Mix of market value and affordable properties—to generate the scale and rates of return required by institutional investors, investment portfolios require dwellings for rent at full market value as well as affordable dwellings. One flow on benefit from increasing the number of market value rental properties would be the prospect that some higher income tenants would switch from lower rent properties, opening access up to lower income tenants.
4. Facilitate a mix of investors—to achieve both competitive pricing and greater liquidity the market requires both institutional and retail ('mum and dad') investors. The Housing Supply Bonds proposal developed for AHURI (Lawson et al. 2012) provides one example of how this could be achieved by tailoring bond issues with different characteristics for different investor classes.
5. Foster specialist intermediaries—to help deliver scale and liquidity for institutional investors (and overcome fragmentation), specialist intermediaries would pool together larger portfolios of different types of rental investment opportunities in a range of locations and managed by a variety of providers. Such intermediaries could enhance liquidity by having the capacity to purchase, as well as offer, any securities issued. A proposal for an Australian Housing Finance Corporation for this purpose has also been developed for AHURI (Lawson et al. 2014).

The prospects for viable investment

The panel expressed strong confidence in the desirability, feasibility and potential of large scale institutional investment in rental housing.

Such investment would need to offer a secure form of low-risk investment based primarily on cash flow. This type of product would be attractive to superannuation funds holding an increasing share of their funds in the 'pension phase' (through the ageing of their membership); to self-managed super funds requiring steady returns; to super funds seeking to diversify their investments; and to overseas financial institutions attracted to the stability of the Australian economy.

The panel argued that if the rate of return is adequate, the structures and vehicles for investment are likely to be created by the market but may need government support to become established. Once the first institutions have made substantial investments in the market, the risk profile will change and become more favourable for further institutional investment.

POLICY IMPLICATIONS

Panel members emphasised that achieving investment goals will require strong government leadership and sustained policy commitment to underpin investor confidence, and they recognised that it will take some time for a robust institutional market in rental housing to develop.

The panel recognised that significant efforts have been made by Australian governments in recent years to generate an investment market for affordable rental housing, triggered especially by the introduction of NRAS. The panel believed that it is urgent that the resulting momentum is consolidated and built upon quickly, especially to attract institutional investors who have yet to take up NRAS incentives.

The main ideas generated by the panel for how governments could best assist the development of a sustainable market for larger scale investment in rental housing assets were:

- Providing certainty to investors through governments making a long-term bipartisan commitment to achieving affordable housing supply through the institutional investment sector, including ensuring continuity of a suitable subsidy mechanism, such as NRAS.
- Working closely with the financial industry to establish the conditions that will lead to an initial tranche of investment by institutions. A task force for this purpose was proposed.
- Offering a 'proof of concept' phase of investment options to test market preferences and build track record and, thereby, help to determine the longer term policy directions required to sustain the market. This could include offering a nationwide portfolio of development ready sites on government and private land, and targeting other incentives, such as NRAS, to the institutional sector. A guarantee on rental returns for a limited time period could be used to reduce investors' perceptions of risk associated with a new asset class and to increase their willingness to make initial investments.
- Supporting the construction of additional affordable housing, especially by offering a revolving loan fund for house building. A potential model involves registered community housing providers developing housing that can be sold on completion to institutional investors and leased back to the housing providers to manage.

FURTHER INFORMATION

This bulletin is based on AHURI project 71016, *Financing and institutional arrangements for the provision of affordable rental housing in Australia (Investigative Panel)*.

Reports from this project can be found on the AHURI website: www.ahuri.edu.au or by contacting AHURI Limited on +61 3 9660 2300.

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Australian Housing
and Urban Research Institute

ADDRESS Level 1, 114 Flinders Street Melbourne Victoria 3000 TELEPHONE +61 3 9660 2300
FACSIMILE +61 3 9663 5488 EMAIL information@ahuri.edu.au WEB www.ahuri.edu.au

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