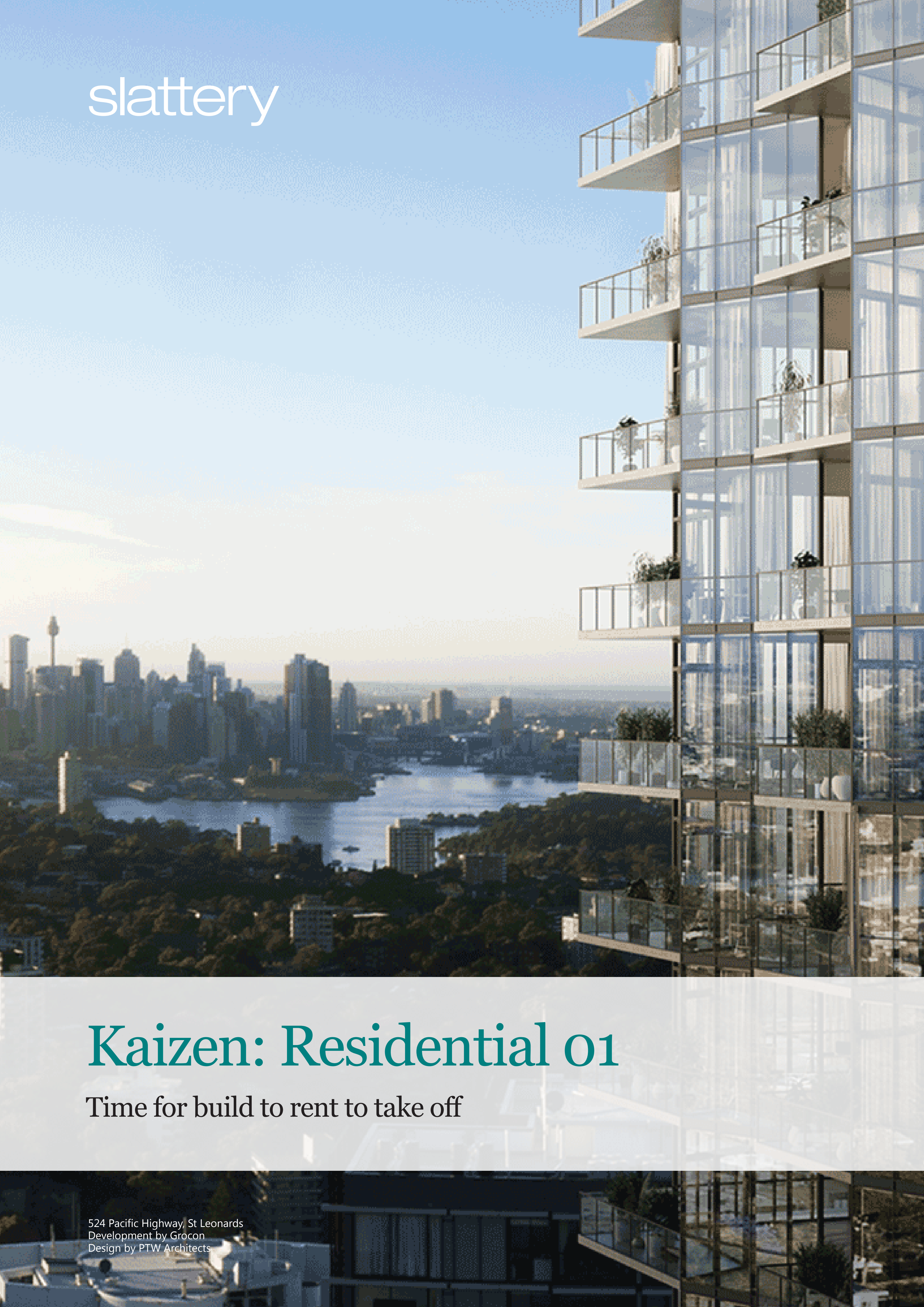


slattery

Kaizen: Residential 01

Time for build to rent to take off

524 Pacific Highway, St Leonards
Development by Grocon
Design by PTW Architects

Time for build to rent to take off

Build to rent is yet to gain a strong foothold in Australia. Slattery's residential team investigates how practical and cost-effective design can help build to rent take off.

One in three Australians are renters – and this number is rising – so it's no surprise that build to rent has been a hot topic in the Australian property industry for the past two years.

The asset class, which has been hailed a panacea for housing undersupply and affordability in our major cities, promises to improve the residential experience, offers longer-term tenure and professional lease management, and adds to the range of housing options.

A build to rent scheme can also be a job generator, supporting between 10 to 12 full time positions over its lifetime including community managers, leasing professionals, facilities managers, housekeepers, event managers and landscapers.

Australia was expected to follow the lead of other countries, notably America, Canada and the United Kingdom, where large institutional investors and pension funds have embraced this new asset class of long-term rental properties.

The build to rent asset class is well established in the United States, where it is known as multi-family residential. The sector currently represents more than 25% of the NCREIF Property Index, the world's largest database of real estate assets tracked by the National Council of Real Estate Investment Fiduciaries. In comparison, office assets account for 35% for total market value.

In the UK, the build to rent sector has grown rapidly. According to the British Property Foundation, more than 157,000 build to rent units are either completed or planned. This includes 43,000 complete, 34,000 under construction and a further 80,000 with planning permission.

In contrast, Australia's uptake of build to rent has been slow. This is despite many superfunds, international investors and property developers expressing interest.

In Australia, Grocon pioneered build to rent with a development within the Commonwealth Games athletes village on the Gold Coast and since then has acquired several sites in New South Wales and Victoria, targeting executive tenants with its Grocon HOME model.

The biggest mover in the market has been Mirvac, which launched its $1 billion build to rent 'club', backed by funding from the Clean Energy Finance Corporation, in 2018.

Mirvac's $200 million Indigo development at Sydney Olympic Park is now complete and three Melbourne projects are underway at Queen Victoria Markets, Brunswick and Spencer Street. Altogether, Mirvac has 1,600 build to rent apartments either in the pipeline or completed.

Oxford Properties, the real estate investment arm of one of Canada's largest pension funds, has entered the build to rent market in Australia with a 39-storey residential tower above Pitt Street Metro.

Greystar, which manages around $160 billion-plus of assets across 200 global markets, recently acquired two adjoining sites in Melbourne's South Yarra with the intent to build a mixed-use precinct with more than 500 apartments.

Additionally, investment firm Qualitas has secured $125 million from the Clean Energy Finance Council to establish a new fund for energy efficient, low-emissions build to rent buildings. Qualitas has already identified a pipeline of five significant projects totalling $700-plus million in loans.

The Mews, South City Square, Woolloongabba
Developed by Pellicano
Designed by DBI Architects

Build to rent challenges in Australia

Despite these emerging green shoots, build to rent has been slow to take off for four reasons:

1. Rates of return: Build to rent is typically characterised by relatively low rates of return when compared to other asset classes such as commercial office.

2. Unknown risks: The traditional Australian build to sell model provides high levels of return and helps people secure home ownership. The model is well established in a risk-averse industry.

3. Perception: Large property funds are often perceived as competition for 'mum and dad' investors. This 'big business verses the Aussie battler' attitude has impeded the development of smart and supportive policy.

4. Taxation: The tax system currently hinders the build to rent model.

Taxation is the biggest handbrake on the development of build to rent, so we'll unpack the details further below.

Land tax

Land tax varies from state to state, but generally operates on a sliding scale. In New South Wales, for example, the basic land threshold is $629,000 and the land apportioned to one residential unit is unlikely to cross that threshold. However, in a build to rent scenario, the entity will far exceed the tax threshold as it holds all units within the development. This puts build to rent at a disadvantage as land tax will be paid over the life of the investment and erode the overall yield.

GST

When developing a residential building GST is paid on input costs. Full credits for GST can then be claimed back on these input costs once the units are sold, if still deemed new, as per tax legislation.

Developers of office, retail or industrial assets can also claim back full GST credits, because the asset will be used for commercial activity.

Current legislation classifies build to rent as residential development. But, because the asset is held for longer than five years, the long-term owner or investor cannot claim GST credits because the asset is not deemed new.

Withholding tax

Institutional investors, especially foreign investors, commonly invest through Managed Investment Trust (MIT) structures to take advantage of lower tax rates. The top company tax rate is currently 27.5%, but will fall to 25% by 2021-22. In comparison, the tax rate for MITs is just 15%.

This provides an obvious investment incentive, and has underpinned the development of commercial real estate across Australia.

Currently MIT entities are unable to buy or develop residential assets, including build to rent, unless it is deemed affordable housing. This is a clear disadvantage to build to rent, especially as significant investment demand is international and an MIT is deemed a foreign entity if 20% of the owners are non-residents.

Pitt Street South Tower, Sydney
Development by Oxford Properties
Design by Bates Smart

Practical and cost effective design

The competition for development sites in the major cities is fierce, with both local and international investors looking to build their portfolios in a growing economy. Build to rent is in competition with a host of other asset types, from mixed-use to commercial office, student accommodation to retirement living.

A summary of build to rent construction costs is detailed below.

Functional area	Brisbane		Melbourne		Sydney	
	Range		Range		Range	
	Rate ($/m2)	Rate ($/m2)	Rate ($/m2)	Rate ($/m2)	Rate ($/m2)	Rate ($/m2)
Basement car park	1,250	1,800	1,300	2,100	1,500	2,300
Podium car park	1,100	1,600	1,500	2,400	1,500	2,600
Retail (cold shell)	1,650	2,300	1,800	2,450	2,100	2,650
Residential - high rise	2,800	3,300	2,900	3,800	2,900	3,900
Residential - medium rise	2,600	3,000	2,700	3,400	2,800	3,500
Extra-Over - high density	1,000	2,000	1,000	2,000	1,000	2,000
Lobby / Community space / Back of house	2,100	3,200	2,100	3,900	2,100	3,800
Extra over pool - lump sum	500,000	1,000,000	500,000	1,000,000	500,000	1,000,000
Roof terrace	1,500	2,100	1,600	2,600	1,600	2,550
Total building cost (blended rate)	**2,350**	**2,950**	**2,500**	**3,100**	**2,900**	**3,200**
Site preparation and demolition (excl asbestos) – lump sum	500,000	2,000,000	500,000	2,000,000	500,000	2,000,000
External works and services - lump sum	500,000	2,500,000	500,000	2,500,000	500,000	2,500,000
Allowance for works outside site boundary, etc.	Excluded	Excluded	Excluded	Excluded	Excluded	Excluded
Allowance for abnormal ground conditions / site decontamination / remediation	Excluded	Excluded	Excluded	Excluded	Excluded	Excluded
Total building and external works & services cost	**2,400**	**3,050**	**2,600**	**3,200**	**2,950**	**3,300**

To be competitive, build to rent developers must ensure the construction price and cost per apartment is comparable with a build to sell product. This is made more challenging as many build to rent brands provide additional amenity, such as concierge services, dry cleaning facilities and high-end common areas.

The approach to achieving a cost effective design is discussed in the following sections.

View, Rockdale
Developed by PietyTHP
Designed by Fuse Architecture

Functional space and planning

Practical and cost-effective design starts by considering functional space requirements and efficiencies. Every square metre of building area should be utilised and constructed only if it creates revenue, enhances the tenant experience, is functional or an operational necessity. Key areas for consideration include:

Carpark spaces

The town planning requirements for carpark spaces vary from council to council but generally carparking for residential developments are a significant cost. A typical residential development has between 0.7 to 1.1 carpark spaces per apartment.

Build to rent projects could challenge this requirement as shared amenity and community-based living could encourage car share schemes. This is especially important for sites near transport hubs and corridors.

Building cores and circulation

Build to rent can challenge the number of apartments per building core, with longer corridors and cleverly designed lift lobbies replicating hotel efficiencies. This may enable a reduction in cores, lift sizes and speeds, as well as effective space utilisation at the entry level. This will increase density and the dollar per square metre rate but reduce the cost per apartment. The result? Higher net to gross residential efficiency.

Private residential generally targets a 75-80% efficiency, while build to rent targets 80% and more.

Community space and amenity

Build to rent projects designed in the USA and UK have included community space and amenity of between four and 12 sqm per apartment. This is a significant cost impost compared to build to sell, but may provide a point of difference and generate an increase in rental income.

Where possible, designs should utilise existing zones such as lift lobbies, circulation space and building podiums to reduce costs.

The entry level provides space for the permanent leasing office and, potentially, retail space. Other key spaces include dry cleaning, parcel and general storage, cold storage, pet wash, as well as crèche or childcare facilities.

Successful build to rent developments create a sense of place and introduce design elements that encourage long-term occupancy and brand loyalty – a task that is no easy feat.

From a cost perspective, a careful assessment is required to balance costs and returns. For example, a gym will reduce the number of apartments in the building, but may allow for increases in rent and generate revenue from a fitness centre tenant.

The secret is to create flexible spaces that can be adjusted to reflect future demand. Will there be demand for a scheme with a cinema? Could this be converted into a childcare facility in the future if demand and demographics change? These are the types of design questions to answer.

Operations

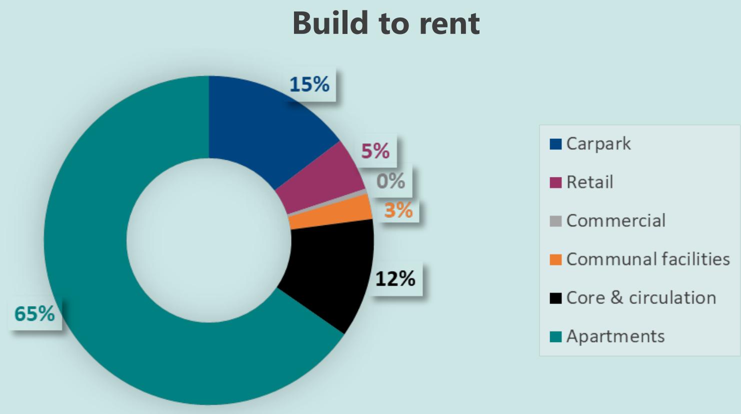
A successful build to rent project considers tenant movements through the building and their experience, as well as day-to-day operational issues, from waste removal to lobby activation, to how the building will accommodate the leasing team, retail tenants and even removalists.

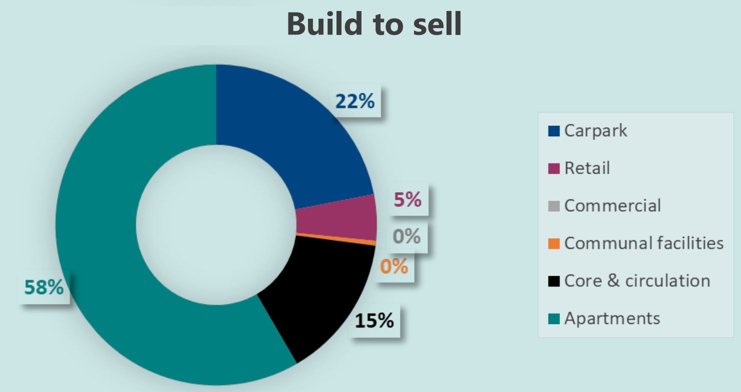
Apartment numbers and size

Build to rent schemes require a critical mass of 200-plus apartments to gain efficiencies of scale and meet long-term running costs. It is also important to rationalise the apartment mix and size to meet the target demographic. Well-designed community spaces and amenity can improve the building experience, reduce apartment sizes while also attracting higher rents.

Build to rent versus build to sell

The graphs below illustrate the differences between build to rent and build to sell development as a percentage of gross floor area on a typical project in NSW.

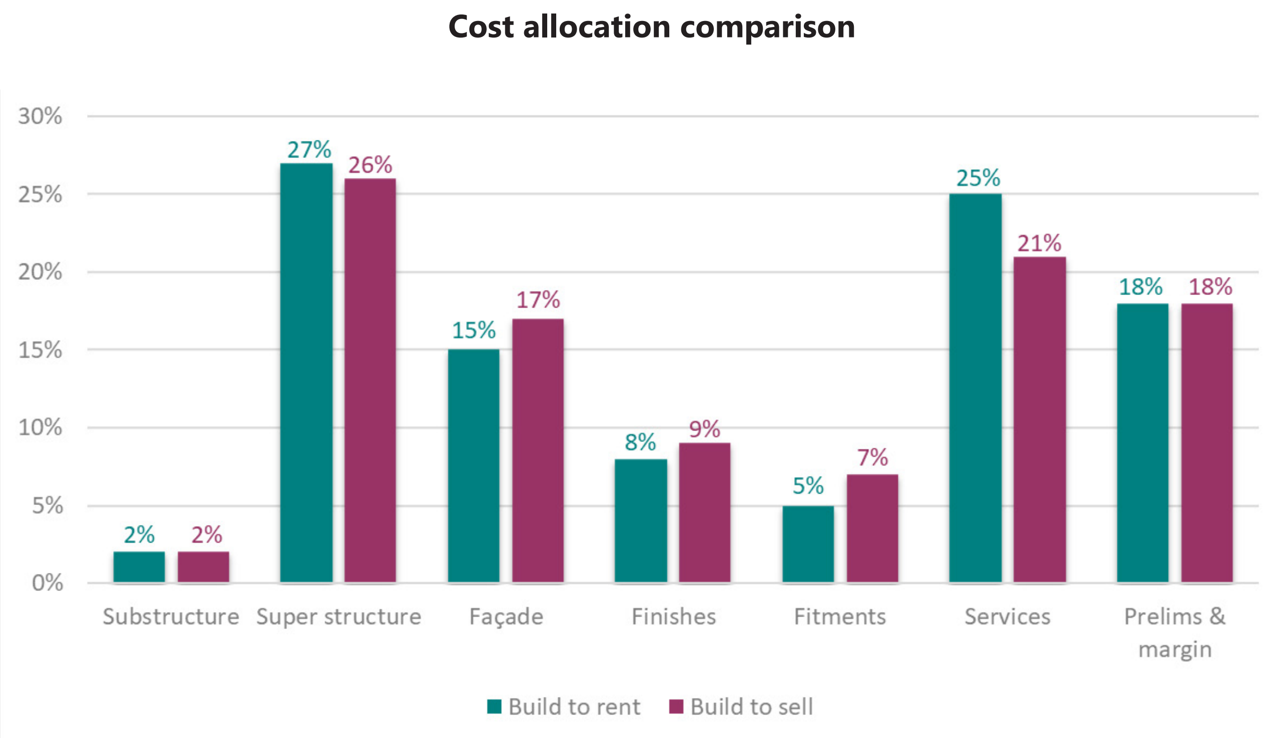




Design specification

Successful build to rent developments in the UK and USA offer tenants convenience and an enhanced living experience. To get the most cost effective design, the design approach should work "inside out" – focusing on the interior amenity that improves the tenant experience, rather than a façade that may attract attention but offer little additional value.

The following is an analysis comparing build to rent versus build to sell elemental cost allocation.



Building fabric and balconies

A significant amount of money can be spent on a façade that does not deliver additional rental income. Project teams must prioritise the pace of construction and cost-effective materials as speed to market is paramount. For this reason, the design specification of a build to rent project may look very different to one for a typical build to sell.

The floor-to-wall ratios are a major factor in achieving a cost-effective design. While the considerations will be site and project specific, balconies can be eliminated if open space is provided through communal facilities if regulations allow. However, in Victoria for example, developments will still need to meet the Better Apartments Design Standards which require balcony spaces.

The project must also balance architectural design and planning requirements with the durability of materials and the cost of their replacement over the life of the building. Operational considerations should make a greater provision for cleaning and maintenance.

Building structure and modular components

The building structure should be designed with repetitious floor and apartment plans, standardised layouts and stacked wet areas, where possible. Successful projects often focus on a lean structural frame and upper floor design with minimal transfers and a regular column grid.

Standardisation lends itself to modular delivery, however there are risks due to lack of competition and a pipeline that is not yet able to drive efficiencies. Modular delivery is currently working in the student accommodation market where repetition is maximised and the program savings offset any capital cost on average against traditional methods.

When it comes to build to rent, clients must prepare to invest long term in a procurement pipeline, fix designs early and limit late design changes.

Apartment fitout

Build to rent apartments demand more durable products that can be easily replaced due to high usage and more occupiers over their lifecycle. Balancing practicality and quality may mean substituting high-end fixtures for those that offer more durability.

Some fitout elements for consideration include:

- **Flooring**: Carpet in bedrooms and laminate or engineered wood elsewhere is often preferred due to cost effectiveness, durability and ease of replacement when compared to tiles.

- **Ceilings**: Savings can be made by minimising bulkheads and ducts.

- **Room sizes**: When designed to suit standard gyprock sheet sizes, this can minimise cutting and wastage and accelerate installation time.

- **Doors:** Solid or semi-solid core doors and robust hardware are best for durability.

- **Cabinetry**: Standard size wardrobes and cupboards can be repeated throughout the building. Standard sheet sizes reduce cutting and wastage. Free standing may also be an option.

- **Kitchens**: Robust kitchen joinery is a priority, while appliance brand names are less important. A build to rent kitchen should be 20% cheaper than a private sale as joinery needs to be easily maintained and replaced. No Italian marble!

- **White goods**: We expect kitchen components to be cheaper as suppliers gain more value from larger deals and as product requirements are better understood.

- **Bathrooms**: Rather than building bathrooms in-situ, bathroom pods can deliver a robust, standardised design and quality. However, the effect of pods on set-downs and floor levels must be considered.

In a conventional scheme, build cost budgets do not include loose furniture fixtures and equipment (FF&E) and a developer would rarely supply beds, bedside units, cupboards and so on. But the appraisal of any build to rent proposal must consider FF&E. This requires consideration of relevant supply chains, detailed procurement plans and procurement deals alongside ongoing budgetary concerns.

From our many years of experience in the hotels market, the Slattery team understand that rooms must be refreshed every five to seven years to maintain the hotel's market position. This work usually includes replacement of fittings, furniture and equipment, minor works and re-decoration. We envisage a similar strategy required in the build to rent market.

Accordingly, assessing the whole lifecycle cost and assessment of replacements, ongoing maintenance and other costs is critical.

Responsibility will sit with the operator to maintain the building's standards, so the ability to replace fixtures and fittings, and the durability of these items, must be factored in. Similarly, the longevity of the building itself must be considered as these schemes are a long-term play and any signs of fatigue will impact on the long-term rentability of the asset. Carefully weighing each of these elements will help operators to secure long-term value.

Mechanical, electrical and plumbing services

Strategies to maintain MEP services are more akin to hotels than private residential, with lifecycle and operating costs at the forefront of the design process. This may mean a higher capital cost but should provide a saving in costs over the lifetime of the building.

Some items for consideration include:

- Centralised mechanical plant
- Exhaust from wet areas to façade or roof
- Air-conditioning controls
- Metering systems
- Low-energy light fittings
- Super highspeed broadband
- Solar installations
- Water re-use
- Dedicated goods lifts.

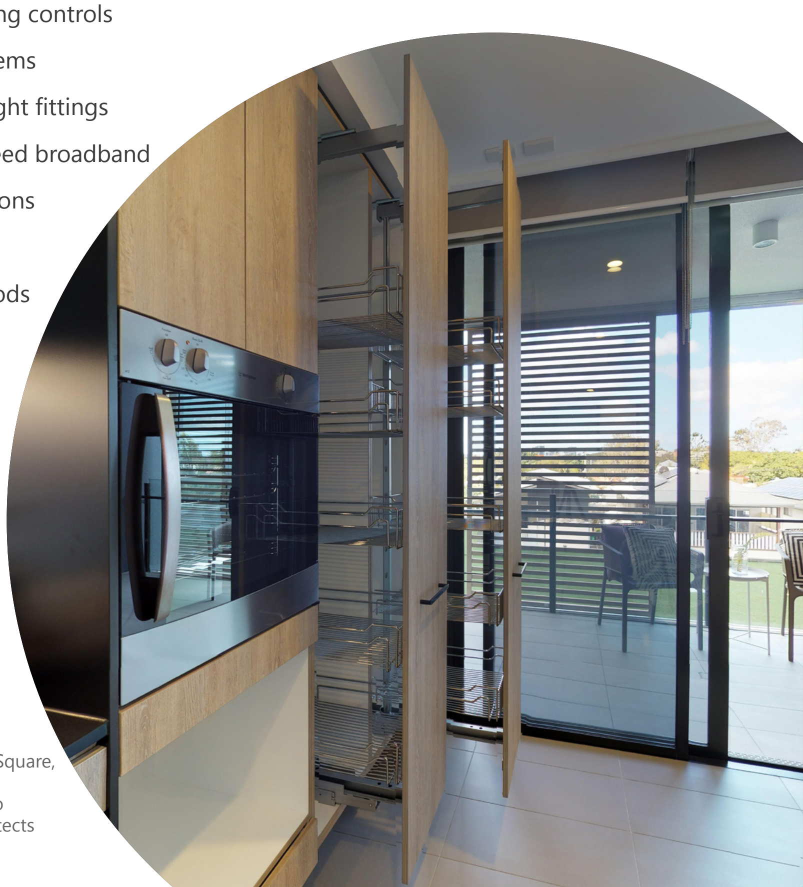
Careful adoption of the right technology will ensure the build to rent asset does not require early refurbishment or become quickly obsolete. Providing technology to individual units, as well as kitchen fixtures, can support tenant retention and brand building. But extended warranty products will be required, and this will become another significant cost to factor in the planning process.

As the operator of the space, the developer will fall liable for the upkeep of these goods. Securing sufficient warranties will minimise that risk but increase costs in the short-term.

Conclusion

In other parts of the world, build to rent is similar to other long-term real estate investments, such as commercial offices and shopping centres. In these offshore markets, build to rent housing is categorised as a low-risk, core real estate asset class for institutional investment.

With the right taxation settings, build to rent can deliver long-term tenure for residents in quality accommodation that delivers solid returns to investors.



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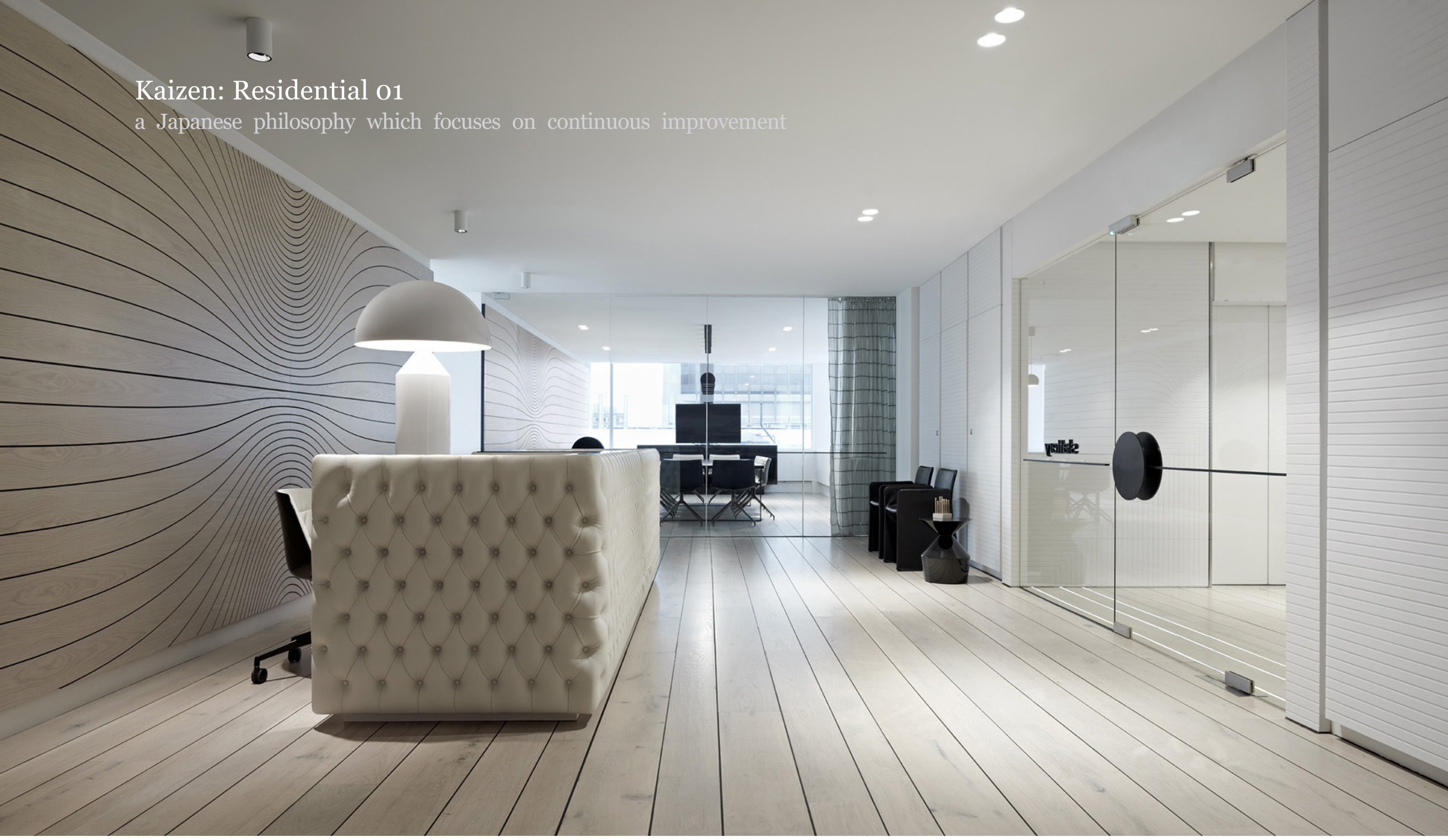

About Slattery & Kaizen

Slattery is a property and construction advisory firm specialising in quantity surveying, cost management and early phase project advisory, with an outstanding history spanning more than 40 years.

We work hand-in-hand with governments, institutions and organisations as well as planners, developers, architects and design teams on a broad range of property and construction projects.

A commitment to excellence and innovation, and an ability to become an integral part of the project team, has earned Slattery the trust and respect of clients and project teams alike. Slattery adds value by taking control and ownership of the cost management process from the outset. We understand this drives innovation and productivity.

Slattery's Kaizen papers focus on sharing knowledge, ideas and pertinent cost information related to our industry. Kaizen is the Japanese word for improvement, and a business philosophy that strives for continuous improvement in process. We produce papers across the sectors we work with, which are shared with our clients and made available on our website for all to view.

We invite you to explore these further at www.slattery.com.au/thought-leadership

Residential—Build to rent team

Slattery has a strong portfolio in residential apartments as well as complementary sectors, student accommodation and hotels. We bring this expertise to inform practical solutions for successful build to rent outcomes.

We understand the importance of balancing commercial viability with tenant requirements. In addition, our approach to assessing the whole lifecycle cost including the assessment of replacements, ongoing maintenance and other costs is critical to achieving long term success.

For more information about build to rent or our residential, student accommodation and hotel sector, please contact Mark Pickerill at mark.pickerill@slattery.com.au