RENTAL REVOLUTION

Artist's impression of Kiwi Property's first build-to-rent community at Silvia Park, Auckland.

BUILD-TO-RENT IS A RISING STAR ON NEW ZEALAND'S INVESTMENT HORIZON. WHAT WILL IT TAKE TO MAKE IT SHINE?

BUILD-TO-RENT IS NEW ZEALAND'S latest emerging property asset class designed to service a new generation of New Zealanders who can't - or don't want to - own their own home.

Development sector insiders believe build-to-rent (BTR) has huge potential to address New Zealand's housing supply and affordability issues, but it requires legislative support from the government for the sector to fully realise that potential.

THE LAY OF THE LAND

The BTR model sees specialist development companies build large residential developments designed specifically for renting, rather than individual sale. The developments are typically multi-unit, high-density-living spaces that can include community or co-working spaces, as well as leased commercial spaces.

Resident leases are often longer term than standard residential rental tenancies, and the ownership company remains responsible for all building maintenance and management.

The developments are generally funded via institutional investors who own shares in a development, rather than becoming the landlords of individual units.

Though the BTR model is common overseas, it is a relatively new asset class in New Zealand, and a new style of living for Kiwi tenants.

Bayleys head of insights and data Chris Farhi says the rise of BTR in New Zealand fits well with the wider transition to more intensive housing, particularly in the main centres, driven by rising house prices, less availability of greenfield land, and social change. Building consent data shows consents for apartments and townhouses have increased significantly in the past 10 years.

To date, investment in the BTR sector in New Zealand has been hampered to a degree by the government's 2021 decision to remove interest deductibility on tax for residential investors, and a lack of clarity around how the Overseas Investment Act (OIA) applies to BTR.

In August, Minister of Housing Megan Woods, announced new legislation that will exempt new and existing build-to-rent developments from the interest limitation rules in perpetuity.

The change means owners of build-to-rent assets can claim interest costs relating to these assets for as long as the asset is held and operated as a build-to-rent development.

Woods says the changes give certainty to developers and have the potential to significantly increase the supply of quality rental housing at pace and scale, while giving tenants long-term security allowing them to settle into local communities and schools.

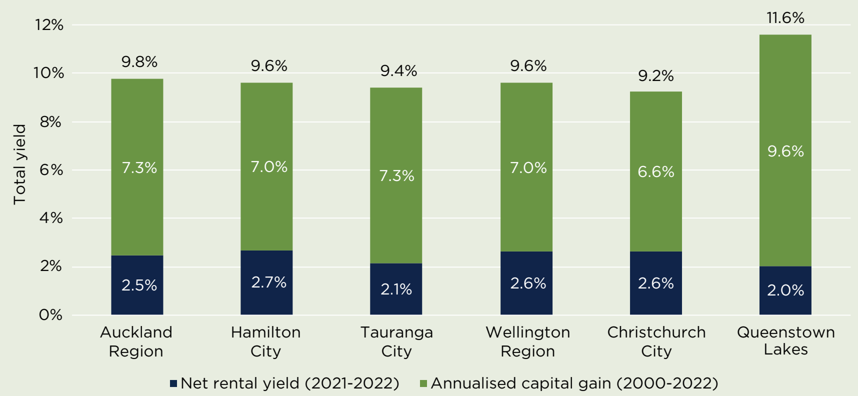
"Everybody knows that there has just not been enough new housing built in New Zealand. While the focus is often on home ownership, the fact is there's a really big gap in availability of rental properties," she says.

"We recognise the enormous role that build-to-rent can play in meeting the significant gaps in Aotearoa New Zealand's rental market. We've seen in Auckland and Canterbury, where there has been significant new supply, that the rate of rent increases has been consistently lower than in other parts of the country."

To be exempt from the tax deductibility rules BTR developments must comprise at least 20 dwellings belonging to a single owner.

When it comes to overseas investment, Woods says the government has looked closely at the rules and how they apply to the sector. "In March this year, the Overseas Investment Office issued guidance regarding the application of the Overseas Investment Act for build-to-rent developments. We expect this can provide the clarity and confidence needed to encourage the institutional investment needed for build-to-rent."

RESIDENTIAL INVESTMENT TOTAL RETURNS FOR MAJOR CITIES



Cities are the Tier 1 Urban Environments used by the government plus Queenstown Lakes (added due to growing proportions of multi-unit developments). Net rental yield based on proprietary data developed by Bayleys. Annualised capital gains are based on REINZ House Price Index between January 2000 and July 2022. Results are before debt and before tax.

THE DRIVE FOR CHANGE

BTR industry experts say while any legislative support to free up investment and growth in the sector is welcome, the recent tax announcements don't go far enough.

The Property Council New Zealand has long been a vocal proponent of BTR as a simple, effective solution to alleviate the country's housing shortage, by offering secure, long-term homes for renters.

Property Council CEO Leonie Freeman says the tax deductibility change makes the numbers more viable for potential investors and encourages the building of new housing stock for rental.

"Only interest deductibility in perpetuity would enable investment returns that make sense as BTR relies on long-term patient capital gain," Freeman says.

The next step, she adds, must be clarity in applying the Overseas Investment Act for BTR so it is a clear asset class similar to student accommodation or retirement villages, despite the government issuing a "guidance note" on the issue earlier in 2022.

"The fact a guidance note was even issued is evidence that a problem exists. Our members are quite clear, a 'guidance' note is not legally binding.

"We've checked recently and no one has confirmed large foreign institutional investors sitting at the gate waiting to get behind New Zealand build-to-rent - and they are - have changed their mind. The 'wait and see' game continues," Freeman says.

"We'd like to see tangible changes to the Overseas Investment Act that eliminates the current uncertainty. This will unlock much bigger pools of investment.

The Property Council also wants access to depreciation for BTR. "It should be simple to link OIA elements into the asset class, along with the introduction of depreciation. BTR is like a 'commercial' type of living and commercial assets already enjoy depreciation benefits so why not BTR too?"

The council's position is backed by those who have committed their businesses to major BTR developments.

Resident Properties specialises in smaller-scale BTR projects in Auckland's inner suburbs where many have been priced out of the housing market.

Managing director Greg Reidy says though the sector is new to New Zealand, BTR is one of the more developed property sectors in the world. Overseas investors understand its potential and allowing them to invest in New Zealand's BTR is essential.

"Build-to-rent businesses are, by nature, large and as a result global. Without opening it up to the rest of the world, BTR may flounder here," he says. "It needs to be easy for overseas inventors to get involved in New Zealand. We're a small market so it's not necessarily going to be attractive to overseas investors unless it's easy."

While the recent tax announcements are good news, particularly in a climate of rising construction costs and interest, Reidy says, it's important to put the announcements in the context of gaining back a tax position recently lost, rather than adding something new.

"At the moment we are an outlier. Our tax position is tougher compared to the rest of the world. We didn't have interest deductibility and we still don't get depreciation tax deductions."

Kiwi Property is on track to open its first build-to-rent (BTR) apartments at Sylvia Park in Auckland, in 2024. Future BTR developments are planned by Kiwi Property at LynnMall in west Auckland and Drury, south of Auckland.

Kiwi Property head of communications and investor relations Campbell Hodgetts says Kiwi Property's strategic vision is to create thriving mixed-use communities.

Most of Kiwi Property's assets already have a strong retail component.

> **"WE'D LIKE TO SEE TANGIBLE CHANGES TO THE OVERSEAS INVESTMENT ACT THAT ELIMINATES THE CURRENT UNCERTAINTY."**
>
> LEONIE FREEMAN, CEO, PROPERTY COUNCIL NEW ZEALAND

With Sylvia Park they are moving forward with their plans to evolve it from a retail-centric destination into an urban village where Kiwis want to live, work, shop and play.

"We are doing this by bringing together the best of retail, office and residential – all in one place!"

Currently at Sylvia Park, construction of the second office block - 3 Te Kehu Way is well underway and expected to open mid-2023, signalling the next step in creating a thriving commercial hub and continued evolution of Sylvia Park into a world-class mixed-use asset.

"What's most exciting in the evolution though is the addition of residential in the form of BTR apartments."

Hodgetts agrees the government's recent tax announcements have lent weight to the idea that BTR has a key role to play in addressing New Zealand's housing crisis.

"Designed specifically for long-term tenancy, BTR offers residents convenience, flexibility and access to outstanding facilities. With home ownership becoming increasingly unaffordable for many in New Zealand and renting on the rise, we believe BTR has the potential to help ease the housing shortage."

"But we do think there is an opportunity to go further.," Hodgetts says. "A more favourable treatment of depreciation, for example, would stimulate greater investment in BTR and help accelerate its growth."

THE INVESTMENT APPEAL

Consensus within the sector is that BTR is a long-term game for investors but will offer good, stable and consistent returns.

Bayleys insights analyst Eos Li says investors looking at the validity of BTR as an asset class could look at the strong return profile (rental yield and capital gain) of residential investments over the past two decades, aided by high demand from tenants and systematic reductions in interest rates.

Hodgetts says that BTR also has the potential to give investors exposure to a commercial asset class they may not have previously considered or been able to access.

"The residential sector has performed well over a number of years, delivering strong capital growth. With BTR, investors can access the benefits of residential property investment at scale, with the prospect of achieving good returns at low risk."

Kiwi Property projects director for Sylvia Park and BTR Greg Tolley says a key point for investors is to look for projects operating at scale, that allow for robust systems, clear growth strategies and good returns. As an example, at sites like LynnMall and Sylvia Park, Kiwi Property has operational systems already in place that can be adapted (and moulded) to residential sites.

The company is also investing in digital technology to facilitate building operations and tenant services.

With plans for developing up to 1,200 apartments at Sylvia Park over the next 10 years, Kiwi Property is aiming to be the leaders of this exciting new asset class - BTR.

Tolley says the company is looking closely at how different elements of each site will work together so its upfront investment in operational management of the sites can scale as the development grows.

"By developing BTR apartments rather than build to sell, we retain control of the asset, putting us in a better position to deliver a great experience for tenants. Our residential proposition will feature flexible long-term leases, stable rents, professional on-site management, and great service standards," he adds.

"Our aim is to create connected communities," says Hodgetts. "The BTR developments will include an extensive range of services, amenities, and tenant events, designed to bring people together. By bringing together the best of residential, retail and office, we're looking forward to creating thriving and dynamic cities within cities."

Resident Properties is finding its investors like the security that comes with the company retaining ownership and ensuring a high level of maintenance. Reidy says investors also like the company's hands-on approach to building its developments.

"Our investors appreciate that we generally build the buildings ourselves. By typically building for less than the property is worth, there is an immediate improvement in capital gain," he says. "Plus there is a huge and growing demand from residents, and there is good market rental growth."

Though economic headwinds such as the cost of building and rising interest rates may slow the sector slightly in the short term, Reidy believes the overall future for BTR is healthy, pending government legislative support.

"This is a long-term business and it could take a little while to catch on but, in the meantime, hopefully the government does improve regulations to make it more attractive."

"While there is clearly some volatility in the current market, we're looking past that. BTR is a long-term proposition for us. We're thinking 20, 30 or 40 years into the future and are really excited to be at the forefront of BTR's rise in New Zealand," says Hodgetts.

TENANT DEMAND

Both Resident Properties and Kiwi Property report high levels of demand from tenants interested in this new model of city living in New Zealand, that offers not just tenancy security but lifestyle flexibility. As an example, BTR agreements usually allow for pets, often not permitted in standard rental agreements.

"Our first two properties in Grey Lynn and Mt Eden have certainly attracted strong resident interest," says Reidy. "While there's no question this is a new style of living in New Zealand, compared to our traditional desire to own our own homes, but that is changing.

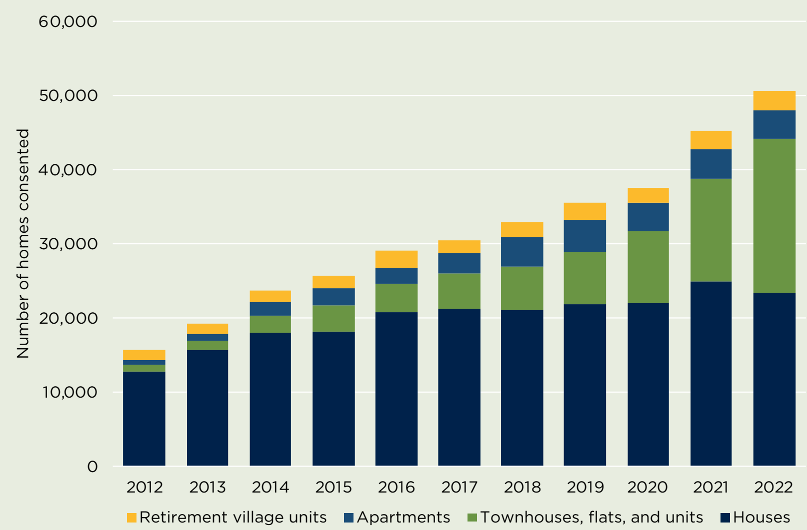
"This offers people the chance to live somewhere that's low maintenance and finished to a very high standard. We provide co-working spaces and community lounges. They're well-resourced in terms of things like bike parking. The idea is you provide a better level of accommodation so people stay longer."

Kiwi Property reports that it already has a waiting list for its BTR properties in development and it will be offering leasing agreements of up to 10 years.

"It's creating a niche market between home ownership and renting," says Tolley.

Resident Properties' The Ed in Mt Eden, Auckland.

BUILDING CONSENTS – NUMBER OF HOMES CONSENTED BY TYPE



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BUILT-TO-RENT

THE ED - RESIDENT PROPERTIES
34 Edwin Street, Mt Eden, Auckland
52-room Quest Apartment Hotel plus 36 rental apartments and community co-working lounge with secure undercroft car parking available for each apartment.

THE NIX – RESIDENT PROPERTIES
18 Chapman Street, Grey Lynn, Auckland
32 one-bedroom and one-bedroom-plus-flexi-room rental apartments, rooftop community lounge and ground floor commercial unit with up to 25 secure car parks next door.

SYLVIA PARK - KIWI PROPERTY
Adjacent to Sylvia Park shopping centre in Mount Wellington, Auckland
295 studio, one-, two- and three-bedroom apartments in three buildings of up to 12 levels, with 119 basement car parks.