

Unlisted wholesale residential property funds can help boost affordable housing supply

AN UNLISTED WHOLESALE RESIDENTIAL PROPERTY FUND IS THE MOST SUITABLE INVESTMENT VEHICLE FOR ATTRACTING LARGE-SCALE INVESTMENT IN RESIDENTIAL PROPERTY IN AUSTRALIA AND PARTICULARLY FOR AFFORDABLE HOUSING.

KEY POINTS

- Australian residential property has been shown to deliver strong long-run risk-adjusted returns, as well as portfolio diversification benefits.
- Unlisted wholesale residential property funds and unlisted wholesale affordable housing funds are innovative ways to encourage institutional investment in the private rental sector in Australia, because they are managed by experienced fund managers and produce stable income yields with low tenancy risk. For these reasons, the funds are likely to be desirable to institutional investors and effective residential investment models.
- A proposed unlisted wholesale residential property fund could enhance returns for institutional investors and reduce risk (with return of 7.93% per annum and risk level of 3.78% over 2010–14). Hence, it is an effective investment vehicle that offers a moderate risk-adjusted return, which is higher than that of stocks and Australian Real Estate Investment Trusts (A-REITs).

*This bulletin is based on research conducted by **Professor Graeme Newell and Associate Professor Chyi Lin Lee** at Western Sydney University, and **Dr. Valerie Kupke** at University of South Australia. This research examined the opportunity of unlisted wholesale residential property funds in enhancing affordable housing supply.*

- A proposed unlisted wholesale affordable housing fund would also likely perform well, but not in cases where the returns to affordable housing relative to private rental were relatively low. Nevertheless, it could succeed provided that it is marketed to superannuation funds with a strong corporate social responsibility (CSR) mandate and receives some government support.
- Key enabling strategies include ongoing support from a fund's sponsor, government and the housing industry; selection of effective fund managers; targeted and active promotion of the fund, and a liquidity protocol.

CONTEXT

The demand for private rental properties has increased significantly in recent years. In 2014, the Australian private rental market included 2.4 million rental dwellings and 5 million renters, with most investment by individuals. The lack of institutional investment in residential property stems in part from a lack of investment vehicles suited to Australian superannuation funds.

This is despite the fact that residential investment vehicles have been shown to be an effective tool to encourage institutional investment in housing overseas. It is an innovative way to increase the supply of private rental dwellings, particularly at the affordable end of the market.

RESEARCH METHOD

This research sought to identify the most suitable model to encourage institutional investment in residential property, particularly affordable housing, by comparing the characteristics of listed and unlisted residential investment vehicles. It also sought to quantify the benefits of such investment vehicles by calculating the risk and return levels of Australian residential property compared with the other major assets. Unlisted investment vehicles for rental property and affordable housing were proposed and critically discussed, ahead of them being evaluated using financial modelling.

KEY FINDINGS

Australian residential property is an effective investment asset class

Based on data from 2000 to 2014, Australian residential property delivered strong returns (average of 10.98%), outperforming stocks (8.79%), direct commercial property (10.29%) and A-REITs (6.35%). On a risk-adjusted basis, the returns for Australian housing (with a return-to-risk ratio of 1.89) were considerably higher than for stocks (0.64), A-REITs (0.35) and direct commercial property (1.61).

In addition, a diversified fund would offer portfolio diversification benefits, indicating the strategic role and potential added-value of residential property in an investment portfolio across all Australian housing markets. For example, the study showed that an institutional investor could minimise their housing portfolio risk to 5.66 per cent (compared to rates of between 6.3% and 12.7% for individual markets).

Unlisted wholesale residential property funds are the most appropriate model to attract large-scale investment

Unlisted wholesale residential property funds are the most appropriate model for attracting large-scale investment in residential property in Australia, and particularly for affordable housing investment. Generating high liquidity by listing on a stock exchange is not a critically important factor for institutional investors, particularly superannuation funds which are long-term property investors with clear investment strategies and performance benchmarks.

Unlisted wholesale residential property funds require a significant minimum investment, significant level of total assets, and low debt levels. They tend to be far more stable in their investment returns, because they acquire stabilised yield-producing properties, including high-quality residential properties with low vacancy risk. They also invest in a diversified housing portfolio by location. These investment features meet the appetite of institutional investors interested in yield, as well as capital return.

The unlisted wholesale residential property fund also overcomes some limitations of direct property investment, such as high management burden, large scale of investment and high transaction costs, by pooling the costs of professional asset management across a large number of properties.

A proposed unlisted wholesale residential property fund is an effective residential investment vehicle

As part of this project, an unlisted wholesale residential property fund was modelled for attracting institutional investment in residential property. The fund had many of the characteristics listed above, including a diversified portfolio, reputable fund manager and property manager, stable income and low tenancy risk.

Performance and portfolio analysis suggest that the proposed unlisted residential property fund offers a moderate risk-adjusted return (2.10%), higher than for stocks and Australian Real Estate Investment Trusts (A-REITs). This reflects higher annual returns (7.93%) than stocks and bonds (but not A-REITs) and also moderate risk (3.78%) compared to A-REITs and stocks. This effectively demonstrates its value for institutional investors as an asset that has moderate returns and risk (see Table 1).

The unlisted wholesale affordable housing fund would need a strong CSR mandate, improved clarity about risk, and government support to be viable

The unlisted wholesale residential property fund may not be the most appropriate to increase the housing options of low and moderate-income households, as the inclusion of affordable housing in its housing portfolio is not mandated. Hence, an unlisted wholesale affordable housing fund is separately proposed. This fund has a very similar structure and features as the unlisted wholesale residential property fund, except that it has a strong CSR mandate to encourage superannuation funds to invest in affordable housing.

Financial modelling of the unlisted wholesale affordable housing fund showed lower returns compared to the residential property fund (though these were still higher than cash and bonds), and lower risk relative to A-REITs and stocks (see Table 1). However, this assumed that the returns to affordable housing were only 42 per cent less than for private rental (in the absence of Australian data, this is based on historical data from the Netherlands). When a more pessimistic discount is assumed (i.e. 60% below the rate of return on private rental dwellings), the annual return to the

TABLE 1: THE PERFORMANCE OF UNLISTED WHOLESALE RESIDENTIAL PROPERTY FUND, UNLISTED AFFORDABLE HOUSING FUND AND MAJOR ASSETS: 2010–14

Asset	Annual return	Annual risk	Return-to-risk ratio (ranking)
Residential property fund	7.93%	3.78%	2.10 (4)
Affordable housing fund (a=0.42)	4.36%	2.46%	1.77 (6)
Affordable housing fund (a=0.6)	3.08%	1.59%	1.93 (5)
A-REITs	9.38%	8.69%	1.08 (7)
Stocks	7.52%	12.96%	0.58 (8)
Bonds	4.19%	0.89%	4.71 (2)
Cash	3.83%	0.95%	4.04 (3)
Direct commercial property	11.01%	1.56%	7.07 (1)

Source: Authors' compilation

fund was less than bonds or cash. At that rate, the fund would only feature in mixed-asset Australian superannuation portfolios at low risk levels. This highlights the importance of reliable information about affordable housing to further examine its strategic role in an Australian context.

POLICY IMPLICATIONS

The government and property peak agencies should promote the use of the unlisted wholesale residential property fund as an effective vehicle for attracting large-scale institutional investment in the Australian private rental market. The unlisted wholesale affordable housing fund is also likely to be effective for attracting long-term institutional investment in affordable housing, thereby addressing present critical needs of low-income renters, provided income yields can be improved.

Successfully facilitating the creation of these funds will require a range of initiatives by policy-makers and stakeholders, who need to act in concert, including:

- *Reshaping the policy settings on taxation* to make affordable housing funds an attractive proposition relative to an unlisted wholesale residential property fund. Providing a company tax exemption for the unlisted wholesale affordable housing fund might enhance the income yield and bridge the return gap between affordable housing and high-quality properties.

- *Promoting Socially Responsible Investment (SRI)* as a way of increasing superannuation funds with a CSR mandate and thereby open opportunities for investment in unlisted wholesale affordable housing funds.
- *Facilitating access to reliable information* about affordable housing investments in Australia. Investors (particularly institutional investors) require reliable information about the returns of housing to have confidence to invest. For example, this might be assisted through the creation of an affordable housing index for Australia to benchmark the performance of affordable housing investments (similar to the MSCI Netherlands social housing index).

FURTHER INFORMATION

This bulletin is based on AHURI project 72031, *The opportunity of residential property investment vehicles in enhancing affordable rental housing supply*.

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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