POLICY EVIDENCE SUMMARY November 2024

Encouraging small-scale investors to help deliver affordable rental housing

AHURI

Based on AHURI Final Report No. 432: Incentivising small-scale investors to supply affordable private rental housing

What this research is about

This research examined how governments at different jurisdictional levels can encourage small-scale private investors to provide affordable rental housing.

The context of this research

The lack of supply of affordable housing is an ongoing long-term trend and governments have sought to address the issue by encouraging greater small-scale investment in the supply of affordable rental housing. Although small-scale investors comprise 90 per cent of all property investors in Australia and own approximately 23 per cent of all dwelling stock, incentivising small-scale investment in the supply and delivery of affordable private rental housing is a challenge.

The key findings

For this study, small-scale property investors are defined as individuals or households—as opposed to companies, partnerships, trusts, funds and not-for-profits—who own one or two investment properties.

People become landlords for a variety of reasons

Landlords can be either ‘purposeful’ or ‘accidental’. *Purposeful landlords*, or ‘landlord investors’, are those who have deliberately invested in residential property with the aim of leasing it. *Accidental landlords* come to landlordism accidentally—for example, upon inheritance. A recent survey showed that 5 per cent of landlords were accidental landlords.

Many landlords lack sophisticated understanding of housing investment

Many landlords were not sophisticated and tended to invest from a place of ‘sentimentality and informality’ rather than an objective assessment of investment risk and return. Previous research has found that most landlords would be better off financially if they invested their money in superannuation, suggesting that private rental real estate investment is ‘complex, stressful and risky’ and assessment is beyond the average investor’s capacity.

Investors turnover properties quickly, with 25 per cent of landlords leaving the sector within 12 months and almost 60 per cent selling within five years.

There are two models of small-scale landlord investment

This research reveals two main business models: the first model is positively geared ***long-term hold investment*** and the second is ***short-term hold for capital gain investment.***

Long-term hold investors invest on the basis of earning rental income

The largest group of landlords are the **long-term hold investors** (LTHIs), being a mixture of purposeful investors and accidental landlords. They are moderate-income households that invest on the basis of being positively geared, which means they are cashflow-sensitive—particularly in the early years of the investment.

The investment sophistication of LTHIs varies considerably. In general, they purchase cheaper housing in lower value locations and are sensitive to the affordability issues faced by tenants. LTHIs provide a source of affordable rental housing, but do not appear to drive the creation of new stock.

LTHIs seek to own their investment property outright by retirement, if not earlier, and prefer property to other forms of investment, as it is 'safe and secure'. Capital Gains Tax is not a significant consideration, as most do not intend to sell their properties in the near future.

LTHIs are impacted by unexpected financial factors—such as rising interest rates and tenant vacancies—and could not afford to be negatively geared when they experienced financial hardship (negative gearing is when an investor offsets their housing investment losses against other income for tax purposes). Most had experienced increased expenses that reduced their investment profit. However, only some of their losses are recouped through negative gearing so they experienced financial stress. Given their cashflow-sensitivity, these investors were often faced with the need to increase rents.

LTHIs are significantly impacted by interest rate rises because of their cashflow sensitivity. While interest is a tax deductable cost, the benefit only occurs at tax time whereas interest is paid throughout the year. Interest rate increases above expectations meant that some were considering selling their properties.

Depreciation tax allowances were not seen as a consideration. Depreciation deductions are only useful for newer properties, and few of the small-scale investors had newer properties. With rising land taxes, LTHIs argued that inner-city properties were often no longer viable investments, which would reduce the supply of private rental in these areas.

Few LTHI landlords had active asset-management strategies, and instead undertook repairs and maintenance as required. One consequence is an emotional connection to their properties and concern for its condition.

Short-Term Hold for Capital Gain landlords are more sophisticated investors

A much smaller group are **short-term hold for capital gain investors** (STHCGIs). These are high-income households that use interest-only loans, are negatively geared and rely on capital appreciation to create wealth. They typically had portfolios of more than four properties, and/or held higher-value property as well as holding other types of assets. STHCGIs tended to be more sophisticated investors than the LTHIs, and were acutely aware of market trends, tax and other financial considerations.

STHCGI may not be a significant source of affordable housing, as they prefer higher-value properties. They buy property with low-maintenance demands and regularly flip properties, which creates insecurity for tenants. Their other income cushions the impact of interest rate increases that otherwise reduce investment profitability.

Negative gearing is very important to them as it reduces their personal income tax burden and enables higher leveraging. While offsetting rental losses does not fully cover the losses, they are compensated through capital gains. Without the Capital Gains Tax concession, these investors would likely be insignificant in the rental housing market.

> 'While LTHI landlords were often sensitive to tenants' needs, they entered the property market for financial gain rather than to address social inequity.'

Small scale investors need positive cashflow in affordable housing schemes

While LTHI landlords were often sensitive to tenants' needs, they entered the property market for financial gain rather than to address social inequity. The LTHIs are incentivised by schemes that maximise the potential for a positive cashflow—not by financial schemes such as negative gearing and capital gains tax concessions. This research found that the average small-scale investor would need a tax offset of approximately $650 per year for every 1 per cent of market rent discount provided.

These investors also value schemes that assure rental income. Analysis found that it is important to index rental increases to market rates so that investors who lock-in to long-term schemes are not disincentivised.

Landlords generally unaware of affordable housing schemes

Landlords surveyed for the research stated they would only be interested in social or affordable housing schemes that allowed them to realise their required rate of return. Most had heard of the National Rental Affordability Scheme (NRAS), but they knew nothing about it. However, they were interested in the concept. Commonwealth Rent Assistance (CRA) was regarded as important for low-income tenants, and most were willing to accept 'subprime' tenants if assistance met the affordability gap.

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Eighty-one per cent of investors who had engaged in affordable housing schemes found them satisfactory, and between 40 and 60 per cent of respondents would be willing to participate in a scheme such as headleasing or NRAS. Despite this, only 39 per cent of small-scale investors in the research sample were engaged in these schemes, and there were poor levels of awareness of affordable housing schemes. However, when investors became aware of such programs, they were interested in participating in them.

Headleasing can be a 'set and forget' option for landlords

Headleasing involves the leasing of private rental accommodation by social housing providers (SHPs) (comprising state housing authorities or community housing providers (CHPs)), who then sublease these properties to approved households—usually social housing tenants. A market rent is paid to the property owner by the SHP, while the tenant pays a market, social or affordable rent to their social landlord.

Focus groups with SHPs and with small-scale landlords who lease their properties to SHP found the landlords were unanimous in their support for headlease programs. The advantages for landlords included:

- guaranteed rental payments provided cashflow security—such rental guarantees made investors 12 per cent more likely to participate in a scheme
- no loss of rent due to vacancy and no need to advertise for new tenants
- guaranteed make-good provisions provided confidence that the property would be returned in original condition
- reduced administration demands when the property management was signed over to the SHP provided peace of mind and a 'hands free' approach.

While headleasing provides the opportunity for SHPs to obtain property without capital investment, a capital subsidy is often required for make-good provisions and an operating subsidy is required to meet the gap between market rent and social rent. In order to attract investors into long-term headlease schemes, rents cannot fall too far behind market rents. The SHPs considered 10-year leases as desirable and recognised that longer leases should be the basis of a 'set and forget' investment model.

For SHPs, a disadvantage of short-lease periods is when investors fail to renew leases when market conditions mean they can do better outside a scheme—for example, escalating costs or high market rents. Another key issue is attracting the right type of investor: someone who is not emotionally engaged with their property and does not feel the need to maintain active involvement. These 'set and forget' investors are comfortable having a passive, secure investment.

Make-good provisions in affordable housing schemes provide safety for landlords

Make-good provisions provide landlords with confidence that their property will be returned to them in original condition at the end of the lease. Given landlords' concerns about social housing tenants, make-good provisions are a critical aspect of a social housing program that engages with the private rental market.

However, make-good provisions are expensive, and acquiring the funds to make good a property is challenging. On average, it would require approximately $40,000 to repair and refurbish a home after 10 years of occupancy.

The SHP must have very good asset-management systems, with headleased properties treated identically to owned assets. Not doing so means the assets cost *'a lot of money'*. Asset management becomes even more important with hard-to-let properties, as these tend to be in poor condition and are more costly to maintain. Some properties also require modifications, such as for disability accessibility, and these need to be removed at lease expiry.

Investors' survey revealed four key points about affordable housing schemes

An online survey of 800 small-scale property investors revealed:

Financial conditions of the scheme are the most important determinant of investor participation. The average small-scale investor would need a tax offset (or equivalent) of roughly $650 per year for every 1 per cent market discount provided. They also strongly value schemes that assure rental income over a specific period. All else being equal, investors are 12 per cent more likely to participate in a scheme that provides a rental guarantee.

Investors value flexibility over stability. Investors prefer schemes that have shorter durations that do not lock in their property for an extended period of time.

The average investor would be willing to give up roughly $7,150 in annual tax rebates if there was a **make-good provision**. Alternatively, all else being equal, the average investor is 7 per cent more likely to participate in a scheme that offers make-good conditions rather than one that does not.

Between 40 and 60 per cent of **investors would be willing to participate in schemes** similar to NRAS or headleasing. From a policy perspective, there is a need to develop a more effective communication strategy to incentivise investor participation.

CHPs see large investors as less of a risk

CHP participants noted that while small-scale investors were important in the community housing ecosystem, they would prefer to work with large-scale investors who presented a smaller risk. Small-scale investors generated instability in the market because they were highly vulnerable to interest rate changes.

Overall, policy makers and CHPs preferred that government incentives were directed to CHPs rather than small-scale investors, as CHPs were seen to provide more secure, long-term solutions and less instability for tenants.

What this research means for policy makers

LTHIs need incentives that address their cashflow needs. These could include:

- NRAS-like schemes targeting new supply that include monthly support payments
- Increasing CRA, because this enables landlords to capture higher rents and be less concerned about cashflow
- Private rental headlease schemes offering incentives such as payment guarantees and make-good provisions for property damage.

To deter STCGIs, and to moderate house-price inflation, Capital Gains Tax concessions should be reduced and the holding period requirements extended. LTHI incentives could be funded by reducing the participation of STHCGIs in the market (STHCGIs provide very limited benefit to the affordable housing landscape).

Education improves investment awareness

A coordinated national marketing and education program targeting LTHIs to increase awareness of incentive schemes (such as NRAS or headleasing) could improve participation in these schemes.

Education programs aimed at improving financial literacy could filter out vulnerable investors before they enter the affordable housing market, thereby minimising disruption caused by financial overcommitment. Adjusting prudential regulations could also support the goal of filtering out inappropriate investors.

Methodology

This research reviewed national and international evidence on affordable private rental housing schemes; conducted interviews and focus groups with small-scale investors and asset managers across Australia; undertook a nationwide online survey of 800 small-scale investors; and held a workshop with nine policy makers.

To cite the AHURI research, please refer to:

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