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Implications of the National Rental Affordability Scheme on the Valuation of Residential Property

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Abstract

The provision of shelter is a basic need and in Australia there has been a history of home ownership. However recent economic growth and rising construction costs, particularly over the past decade, has placed home ownership out of reach for some. In response to increased affordability pressures, the Australian Federal Government established the National Rental Affordability Scheme (NRAS) in 2008.

The aim of establishing the NRAS initiative is to stimulate the supply of new affordable rental dwellings, targeting 50,000 new properties by June 2012, through the provision of a National Rental Incentive for each “approved” dwelling. To be approved the dwelling must be newly constructed and subsequently rented to eligible low and moderate income households at rentals no greater than 80 percent of market rates. There is a further requirement that the accommodation be provided as part of the scheme for no less than 10 years.

The requirement to provide new residential accommodation at below market rentals for no less than 10 years has an impact on value and as such the valuation methodologies employed. To give guidance to valuers this paper investigates the scheme, the impact on value and expectations for the future.

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Introduction

The provision of shelter is a basic need and in Australia there has been a history of home ownership with rental housing being viewed only as a transitional stage to housing ownership and for temporary accommodation only (Susilawati[1] 2009). However housing stress has reached historical highs with recent economic growth and rising construction costs, particularly over the past decade, placing home ownership out of reach, particularly for low to moderate income earners.

The arena of affordable housing has been clouded with both social housing and affordable housing. Social housing, also known as public housing or community housing, is typically government owned or funded housing where rents are not set at market levels for a profit return but rather to satisfy societal housing needs (Phillips 2009). Alternatively, affordable housing, also known as workforce housing or intermediate housing, is a mix of publicly and privately owned housing rented at rates below market rates (Milligan et al 2004, Milligan et al 2009, Lawson et al 2010)

Various initiatives have been established to alleviate these affordability pressures, including the Australian Federal Government establishment of the National Rental Affordability Scheme (NRAS) in 2008 to target affordable rental housing for key workers, which is the focus of this paper. To give guidance to service providers, investors and valuers this paper investigates the scheme, the impact on value and expectations for the future.

Research Methodology

This paper is based on the views and opinions expressed by a range of participants in the provision of affordable residential rental accommodation through semi-structured interviews during 2010. Research through semi-structured interviews allowed the interviewees to talk freely about the issues, actual experiences and practices with regard to the National Rental Scheme and implications for valuations. The interviewer was thus able to pursue particular lines of discussion with regard to past and current experiences and outlooks for the future in a more exploratory manner (Saunders 2003).

The range and scope of experience of the ten interviewed participants was diverse and provided a cross section of opinions and reflected perspectives from senior personnel within affordable housing providers, financiers, developers/development managers, valuers and academics. More particularly, the interviewees may be summarised as follows:

Table 1: Summary of Interviewees

	Position held by Interviewee	Interviewee's Organisation
1	Chairman	Affordable Housing Provider
2	Chief Executive Officer	Affordable Housing Provider
3	Chief Executive Officer	Affordable Housing Provider
4	Tenancy Manager	Affordable Housing Provider
5	Development Manager	Affordable Housing Provider
6	Director	Valuation Firm
7	Valuer	Valuation Firm
8	Director	Property Developer
9	Development Manager	Property Developer
10	Academic	University

The interviews followed three principal themes:

1. What is NRAS and how is it working;
2. What are the valuation opportunities and methodologies being applied; and
3. What are the opportunities for the future.

The primary intent of the research was to gain preliminary information on the NRAS, valuation issues and to consider future opportunities or limitations. Further qualitative and quantitative research is to be undertaken during 2011 as part of a broader research project into affordable rental housing.

National Rental Affordability Scheme (NRAS)

The National Rental Affordability Scheme (NRAS) is an Australian Government initiative that subsidises the supply of affordable rental dwellings by payments to contracted organisations to assist Australians with low and moderate incomes to access affordable, safe and sustainable housing. The scheme is targeting the supply of 50,000 new affordable rental dwellings over a four year period (Milligan 2009).

Since its commencement the scheme has seen four application rounds opened since July 2008, and 12,830 incentives have been allocated. There were 1,816 affordable rental dwellings available for rent at 20 June 2010 (FaHCSIA[1] 2010). More particularly the 2009-10 Annual Report showed the take up of incentives as follows:

Table 2: Summary of NRAS Incentives

Deliverable	Target	Result
Number of incentives planned	7,500	1,526
Round 1 incentives allocated/reserved	n/a	3,618
Round 1 incentives allocated/reserved	n/a	7,075
Round 1 incentives allocated/reserved	n/a	2,137
Total number of incentives allocated/reserved	50,000[a]	12,830[b]

[a] *Total to be delivered by June 2012*
[b] *Total allocated as at 20 June 2010*

In late 2010, the timeframe for the rollout of the 50,000 targeted dwellings was extended from 2012 to 2014. By October 2010 approximately 18,000 incentives had been allocated with a criticism of the scheme being that only 2,500 dwellings had actually been constructed. Given the nature of real estate, time delays are to be expected between receipt of approvals and delivery of completed stock. The deadline for the program has been extended from 2012 to 2014. (Lenaghan 2010, Morris 2010)

The scheme provides tax incentives and/or grants to encourage providers to construct new dwellings or rehabilitate derelict dwellings, manage tenancies and offer rental rates to low to moderate income households at 20 per cent below market rates for 10 years (FaHCSIA[2] 2010, Lawson et al 2010).

The NRAS aims to:

- increase the supply of new affordable rental housing
- reduce rental costs for low and moderate income households
- encourage large-scale investment and innovative delivery of affordable housing (FaHCSIA[2] 2010).

The scheme is for the provision of new housing stock and involves a 10 year funding arrangement from the government. The benefits of the grants/tax incentives are therefore guaranteed by the government for 10 years, but the owner of the NRAS dwelling may cease being an NRAS unit at any time during the 10 year period. This cessation is without penalty and merely foregoes the future benefits for the remaining balance of the 10 year term. The government takes no hold on Title and has no legal or equitable claim over the property. Consequently there is no obligation on the unit owner remaining in the scheme.

There appears to be primarily two models of operation through which service providers can supply affordable rental accommodation under NRAS. Firstly a “develop and hold model” and secondly a “develop and sell model”. Both models provide opportunities for valuers. Both models would require some form of feasibility support particularly where borrowed funds are utilised. The “develop and hold” model would also provide opportunities for balance sheet reporting purposes.

Prospective purchasers and their financiers would also require valuation support under the “develop and sell model”.

The predominant take up of the incentives under Rounds 1 and 2 of the scheme have been charitable or not for profit entities (Milligan et al 2009). These groups do not pay tax and as such the incentive as a tax reduction is of no real benefit. However as the scheme becomes more widely understood and accepted, participation by the private sector who do pay tax and would benefit from the tax reductions will increase. Further the incentives are being passed on as a cash payment to the not for profits that can then be passed on to investors.

NRAS Tenant Eligibility

The provision of affordable housing has traditionally been broken into two areas, the provision of social housing and the provision of affordable housing. The provision of social housing by government departments has unfortunately been stigmatised, with views that this housing is for the poor and homeless who will not treat the properties well. NRAS relates to the latter group, being a rental accommodation initiative targeting key workers (Lawson 2010, Cubit 2010)

The NRAS scheme is targeting rental accommodation for low to moderate income households. In Queensland, the State Government requires NRAS tenants to be sourced from a wait list compiled by the Department of Communities. The targeted tenants are key workers, and there are income eligibility levels. As at 2010, the income eligibility levels are summarised as follows:

Table 3: NRAS Income Eligibility Levels

Household Type	Entry Income Level	Upper income level to maintain eligibility
Single person	$42,386	$52,983
Two adults	$58,596	$73,246
Sole Parent with 1 child	$58,638	$73,298
Sole Parent with 2 children	$72,695	$90,869
Couple with 1 child	$72,653	$90,817
Couple with 2 children	$86,710	$108,388
Couple with 3 children	$100,768	$125,960

Source: FaHCSIA[3] 2010

The income eligibility is structured to target households at or below the entry income level for that composition of household, and allows the resident to remain in occupation as their income increases over time. Once the upper income level is exceeded over the passage of time, the resident would then be required to seek other rental accommodation.

Valuation Methods

There are many roles for valuers to play within the area of affordable rental housing, much in line with general residential valuations. Primarily valuers may undertake market valuations and development feasibilities at the time of purchase of suitable development sites, at the time of purchase by individual or institutional investors of the completed NRAS unit for mortgage purposes, and the assessment of market rental.

Development Feasibility Valuations

For the developer of residential stock there are fundamentally four unit types that may be provided for:

- Social housing,
- Affordable housing,
- Units for sale on the open market,
- Units for sale with NRAS tenants (Susilawati[2] 2009, Phillips et al 2009)

Whilst developers need to balance the mix within their unit developments to ensure the feasibility of their projects and to avoid the creation of "*stigmatised precincts, ghettos or slums*", this paper is focused particularly on the NRAS units which may be held by the developer as an investment or on-sold to private individual or institutional investors.

The feasibility of sites proposed to be redeveloped should be undertaken together with valuation requirements to obtain development funding. These feasibilities will utilise a residual approach after determining the end product gross realisation and deducting all project costs and an allowance for profit and risk.

Direct Comparison Valuations

NRAS units are typically of a good medium standard constructed to meet the standards of the locality in which they are situated. They are not "*cheap*". Valuers should be adopting the direct comparison approach in determining the end value of the completed units either at the time of feasibility or at the time of sale.

When making direct comparisons between a comparable sale property and the subject property, a valuer needs to consider possible adjustments based on differences in the elements of comparison. (API 2008) Whilst there has been a lack of evidence to date of units selling subject to NRAS, this is changing. A number of NRAS units in Brisbane and other areas have been recently contracted for sale during 2010. As the volume of sale transactions increase, there will be greater evidentiary support for values and reduce the need to move away from it as the source for comparative analysis. Comparisons with non NRAS residential units may also be made taking into account comparative differences.

Preliminary indications are that the NRAS units are selling at a 10% discount to Units built and marketed for sale in the same complex. This is not a two tiered market, but rather a reflection of different inclusions in the units. Affordable rental accommodation has physical differences to that of marketed for sale residential properties. These differences include such factors as greater density of development, smaller room sizes and limited car parking (Susilawati[2] 2009). Consequently the comparison between residential products must take into account the respective physical features, with discounting between a two bedroom NRAS unit and a two bedroom market for sale unit being reflective of physical differences rather than being part of the NRAS.

Exemplifying the volume of activity to date, the Gold Coast Housing Company (GCHC) was one of the first participants under NRAS with their first property being tenanted under the scheme in December 2008. During 2010 the GCHC had 143 NRAS properties in seven locations following NRAS Rounds 1 and 2. Exemplifying the growth expected in this market, under Round 3 at the end of 2010, the GCHC were applying for over 1,200 properties. (Cubit 2010, GCHC 2010) This example shows the time required in any new initiative related to real estate to establish a body of sales evidence from start up. Over the next few years this evidence will be much greater.

Preliminary indications are that the NRAS units are selling at a 10% discount to units built and marketed for sale in the same complex. This is not a two tiered market, but rather a reflection of different inclusions in the units.

Where multiple units are being held or purchased by an institutional grade investor, the capitalisation of income approach may be adopted as an appropriate method. This method employs processes that consider the present value of anticipated future income and expenses (Whipple 2006, Reed 2007, API 2008). Management fees for units under the NRAS scheme are typically 10-15% of the annual income, which is higher than non NRAS units, however this charge is typically all inclusive and reflects the increased management and accreditation costs

Market Rental Valuations

The assessment of market rental is a fundamental part of the NRAS process due to the need to assess the market rental and then applying a discount of no less than 20% to determine the NRAS rental. This assessment of market rental is to occur at the commencement of the First, Fifth and Eighth years of the 10 year NRAS period. Market rental is defined as "the estimated amount for which a property, or space within a property, should lease on the date of valuation between a willing lessor and a willing lessee on appropriate lease terms in an arm's-length transaction, after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion." (API 2008) The most appropriate method to determine market rent is through direct comparison (Whipple 2006, Reed 2007) with other recent lettings, taking into account such factors and differences as:

- The supply and demand for residential accommodation within the immediate area together with current vacancy levels;
- Proximity to other land uses;
- Views and aspect;

- The features and benefits of the properties;
- Age and construction styles;
- Standard and configuration of accommodation;
- Provision of car accommodation;
- Provision of extras such as dishwashers, curtains and other finishes;
- Overall unit sizes;
- Density of development;
- Provision of body corporate; and
- Provision of communal facilities.

Overall valuers involved in this part of the residential sector appear to understand the nature of these properties and there is increasing interest in gaining more knowledge.

Research Findings

All interviewees identified increased opportunities in the future, making comments such as it is "*getting better understood*" and "*a number of people are starting to take advantage*" of the scheme. Consequently as these projects start to be delivered in finished built form there will be greater market acceptance and evidence to support valuations.

Expectations are that "*valuers need to understand what they are doing*" and that "*real problems for the sector will arise if values are inaccurate*". Whilst residential properties are not traditionally referred to as specialised assets, the nature of NRAS has placed another layer of complexity over the asset requiring valuers, developers, investors and others to have an understanding of what is involved.

Some interviewees referred to comments such as "*if rented at 20% less than market then must be worth 20% less than market*" to be fundamentally incorrect and of no assistance to the ongoing provision of affordable housing solutions in Australia.

Opportunities are increasing with interviewees involved with development and investigating affordable housing schemes expressing they are "*keen to know more*", that this area appears "*to be an untapped resource, why is everyone not doing it*" and "*how good is an opportunity underpinned by the government*" and "*it will always be rented*".

Bank Funding

A major issue confronting the provision of NRAS units has been the wariness of Banks and other financial institutions towards this new investment class asset. It would appear that up to 2010, there was poor to limited understanding or acceptance by the financial institutions to lending or investing into NRAS. It is essential to the ongoing provision of affordable housing that there are adequate and robust financing opportunities available (Lawson et al 2010).

A thread from the interviewees indicated that "*three of the majors are currently reviewing the documentation*" and "*one has recently gained internal approval to lend on these assets*". The big four banks have reportedly each employed NRAS specialists (Lenaghan 2010). Consequently there is growing interest and likelihood for financing moving forward.

Overseas examples, including from the United States of America, indicated that it took seven years for the institutional investors to come into the market. It starts with the "mum and dad" investors first and then expands to other investors as the depth to the market develops (Lenaghan 2010, Lawson et al 2010).

Sustainability Issues

Given the income levels of the intended occupants, it is necessary to be conscious of ongoing occupancy costs. Consequently building designs are having regard to passive elements that enhance lifestyle and liveability at minimal cost. These facilities are typically not air conditioned (to save on electricity running costs) and therefore look to incorporating atriums, cross ventilation and living out spaces.

Site selection is also important to the triple bottom line of economic, environmental and social outcomes, by sourcing locations that are close to public transport and facilities. Typically residents do not own motor vehicles which leads to further design savings by not incorporating the maximum number of car spaces that are normally required by local authorities. These initiatives correlate with broader ecologically sustainable principles of conserving resources and maintaining quality of life now and in the future, economically, environmentally and socially (Gurran 2003).

The interviewees involved in the delivery of projects and property development in general were focused on developing larger unit complexes with say 40 to 100 units to gain economies of scale. A concern that arose was "*not to create a stigmatised precinct, ghetto or slum*". Consequently overall design features are important with developments to date and those proposed being built by major construction groups to architectural designs. Several affordable housing facilities have been recognised through State and National design and development awards.

Opportunities for the Future

NRAS will not be the lone solution for the provision of affordable housing into the future, but in conjunction with other programs, and greater acceptance by financiers and take up by investors will assist in satisfying Australia's growing need for affordable rental accommodation (Milligan 2009).

It is important to have regard to the bona fides of the NRAS service provider that will be supplying the ongoing management of the unit. The affordable rental housing provider has traditionally been the government or a not for profit entity, however, other groups including developers are starting to move into this sector to ascertain opportunities.

Consequently when evaluating the quality of an NRAS provider it is relevant to consider the strengths of the governing board, the day to day management, those who are delivering the built form (typically development managers or project managers), the financial team and the housing/tenancy team. The housing/tenancy managers are particularly important as they are involved in the day to day managing of the assets and provide support to the tenants.

A common perception with regard to affordable rental housing is that as it is rented at 20 percent or more below market rental rates, then their values are similarly discounted. However a more accurate picture for the NRAS scheme is that it provides a mix of cash subsidies and tax credits as incentives which when added to the discounted rent, in some instances actually results in an income that exceeds market levels.

Previous expectations of below market valuations led to banks being unwilling to lend to the full value of the property, however with greater understanding of the scheme, the major banks and some credit unions are expected to make funds for development and investment more readily available.

The typical residential landlord in Australia has been private individuals or families, with lesser investment interest by institutional investors (Lawson et al 2010). Consequently portfolio purchases by institutional grade investors have been limited to date. This is to be expected both due to broader economic uncertainty and the newness of the scheme.

More and more Australians are going to rent and a number of these will be looking to access more affordable accommodation. This increasing demand will see NRAS products likely to form part of the market and become increasingly acceptable.

Conclusions

The overall demand for rental housing is increasing, with increasing populations and rising house prices. Home ownership is becoming quite challenging and as such there is a need for private enterprise to be involved in the delivery of affordable rental accommodation.

There appears however to be expectations of discounting in values as soon as "affordability" tenants or schemes are mentioned but this seems inappropriate as a broad statement, with values of individual properties taking into account the characteristics of that particular property with comparable properties that have recently sold. Fundamentally there are no substantial differences between affordable housing and other traditional residential developments, with the quality of housing being on par with residential housing and tenants being key workers on low to moderate incomes.

There are benefits for the government to engage with the private sector and reduce their capital contribution through the provision of ongoing subsidies/incentives. The NRAS incentives are not fully understood by the general market and financiers, however this is changing as the number of units subject to NRAS are developed.

The National Rental Affordability Scheme is a scheme that increases opportunities for the provision of affordable residential rental accommodation, however there are time lags between approval of projects and delivery of completed built residential stock. Financial institutions tend to be wary of new investment products and take time to consider their lending practices. Institutional investors tend to be slow on the uptake, however are starting to show interest in this type of investment. Both bank lending practices and institutional investment into affordable housing have been impacted by global events and tightening of credit during the Global Financial Crisis since 2008.

This paper provides an introduction to the implications of the National Rental Affordability Scheme on the valuation of residential property, however further research is required. The author is involved in a more detailed quantitative and qualitative research project to be undertaken during 2011.

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