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BUILDING TO RENT #2

Issues for regulators

New Zealand's stock of rental housing is under pressure. A fall in housing affordability is leading more people to rent, yet research has found that rental homes are in poorer condition than owner-occupied houses. Looking to the future, there are barriers to growing and improving the rental stock to meet projected needs. Overseas approaches to rental property could offer solutions, but they require regulatory changes.

EXPANDING THE number of private rental homes and lifting their quality is crucial: 78% of New Zealand's rental housing stock is in private ownership. The BRANZ House Condition Survey 2015 found that, on average, rental properties were twice as likely to smell damp and nearly three times as likely to feel damp as owner-occupied homes. Rented houses were only half as likely to be assessed as well maintained. In a separate BRANZ survey, which included data from 339 households that rented, 21% said their home was 'somewhat' or 'very' difficult to heat.

Several changes are already under way. Thermal insulation in private rental properties becomes mandatory from 1 July 2019. The government is also developing new healthy home standards around heating, ventilation, moisture and other areas following passage of the Healthy Homes Guarantee Act 2017.

The BRANZ research reported here takes a longer timeframe, looking several decades ahead. It considers likely longer-term needs and possible ways to meet them.

Rental demand in 2038

BRANZ projections out two decades to 2038 suggest a substantial growth in the number of rental properties. By 2038, there are likely to be 225,000 more rental units over numbers from the 2013 Census.

In addition to a growing number of rental properties, the tenants and their requirements are likely to change. For example:

- many rental homes are likely to be occupied by older tenants – the number of people 65 years or over in rental accommodation is likely to more than double between 2013 and 2038
- by 2038, it is likely that another 11,000 rental houses will require modification to allow tenants with disabilities to live there
- there will be more multi-family households looking to rent a house together.

In many cases, changes in the demographics of renters means changes in the types of rental properties required. Older people and those with disabilities are more likely to require dwellings that incorporate universal design – homes that are accessible to people of all abilities, at any stage of life. Multi-family households may require more bedrooms and multiple common areas such as kitchens. There are currently fewer large rental houses than in the owner-occupied stock. A BRANZ survey found that the number of bedrooms is the second most important criterion for tenants choosing a rental property.

Barriers and solutions

A key barrier to owners of private rental properties upgrading their dwellings is the mismatch of costs and benefits. Owners pay for improvements, such as installing a heat pump, kitchen rangehood or bathroom grab rails, but the immediate benefits (lower energy bills or improved comfort/user-friendliness/safety) fall to the tenants. Owners may not wish to pay for improvements they do not immediately benefit from, and tenants may not wish to pay more for the benefits. There is little incentive for rental property owners to invest in their properties.

Three successful overseas models could be considered for their potential to overcome this problem: the build-to-rent approach, energy performance certificates and real estate investment trusts.

Build-to-rent approach

A new shell and fit-out model is based on the build-to-rent concept. Under this model:

- the owner provides the building shell and a one-off payment towards the fit-out, which is capitalised over the length of the tenancy
- the tenant arranges the fit-out to meet their needs and is responsible for its maintenance
- there is a 5–15-year contract between property owner and tenant, a little like a commercial property lease.

This is a very different model to typical private rental arrangements in New Zealand today. BRANZ calculated different financial outcomes between the existing model, the build-to-rent model and the model where a complete new home (including fit-out) is rented.

The results are striking. The new-build model and shell and fit-out model offer a much higher net present value (NPV) than the existing stock model (Figure 1). Whether the owner sells the property at 10, 20 or 30 years, NPV is higher. The new-build and shell and fit-out models generate a positive cash flow earlier than the existing stock model, primarily due to reduced maintenance/repair costs.

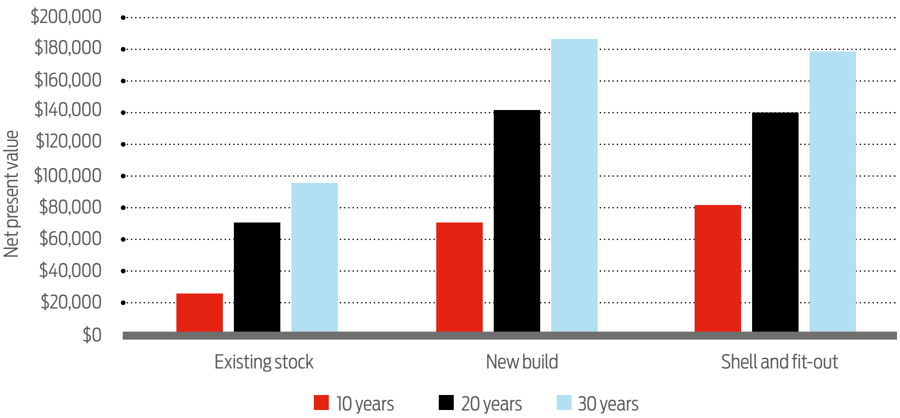

Figure 1. Net present value of different rental models at a 10, 20 and 30-year investment horizon.

The shell and fit-out model has a number of potential advantages for New Zealand, including:

- rental properties that more closely match tenants' needs
- greater security for tenants
- greater length of tenure and income/expense predictability for rental property owners
- enhanced long-term financial benefits to rental property owners.

Implementing the shell and fit-out model would require amendment to the Residential Tenancies Act 1986, recognising that the fit-out is installed by the tenants to their needs and maintained by them. Clauses in the Act that may require change include Contents of tenancy agreement (13a), Rent increases (24), Tenant's responsibilities (40), Tenant's fixtures (42), Landlord's responsibilities (45) and Termination by notice (51) among others.

Energy performance certificates

Energy performance certificates (EPCs) for houses are common in Europe and the subject of a European Union directive. Houses are assessed for their performance and a certificate provided with a rating ranging from A (the most energy-efficient dwelling) to G (a highly inefficient dwelling).

Certificates also include a potential rating to show what a property owner may be able to achieve by making some improvements – an incentive for properties to be upgraded.

The benefit for rental properties is that EPCs help tenants assess the energy efficiency of a house before they sign a lease. Tenants who know that a house is likely to have lower heating costs and/or be more comfortable to live in may be prepared to pay a higher level of rent. (Lower heating bills offset the impact of higher rent.) The prospect of receiving higher rent gives property owners an incentive to invest in upgrading their properties or to buy new or better-condition properties to rent out.

Introducing mandatory EPCs in New Zealand would require new regulations.

In the United Kingdom, since 1 October 2008, tenants who move into a self-contained rented property must be given an EPC by the property owner or their agent (Figure 2). Certificates are valid for 10 years, but property owners can ask for them to be updated after improvements have been made to the property.

From 1 April 2018, private properties rented to new tenants in the United Kingdom must have a minimum energy performance rating of E on an EPC. Homes with existing tenancies must be upgraded to the minimum E rating before 1 April 2020.

In The Netherlands, new tenants must be given a copy of the EPC by the property owner. For sitting tenants, the owner must provide an EPC if the lease took effect on or after 1 January 2008.

There is a significant body of evidence that EPCs can provide incentives for rental property owners to make energy efficiency improvements:

- Dutch researchers have found that dwellings with higher energy efficiency are rented out at higher rates, even

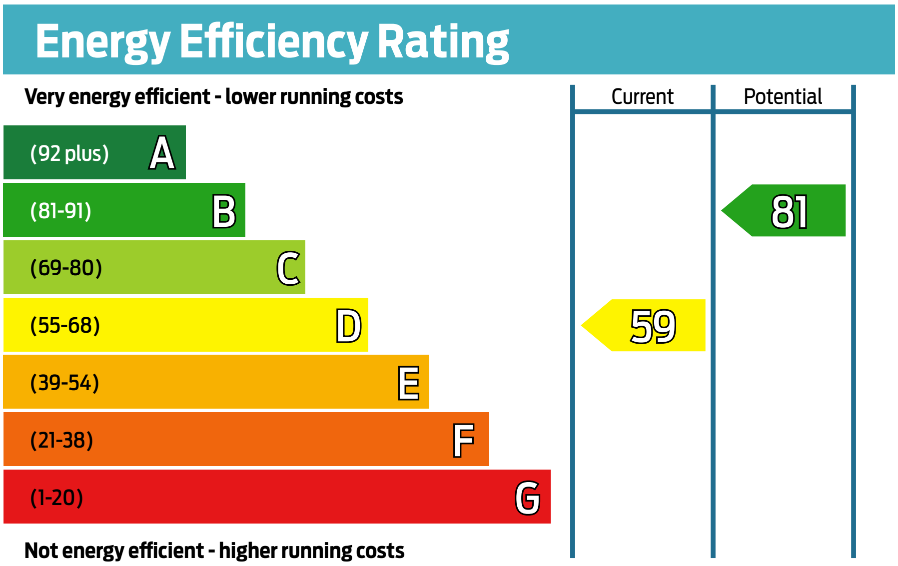

Figure 2. Sample energy performance certificate from England and Wales.

when controlling for property size, age and location.

- Dutch, Welsh and English studies have found that A and B-labelled homes sell at a price premium while G-labelled dwellings sell at a discount.
- A study commissioned by the European Commission in selected EU countries found that higher energy savings resulted in substantially higher sale or rental prices on average.

Real estate investment trusts

Real estate investment trusts (REITs) are investment entities that can increase the supply of rental housing by providing capital for development and sustaining a development pipeline. REITs require considerable scale to be cost-effective.

Individual investors could combine into an REIT to develop the build-to-rent homes described above. REITs have a longer-term view than many smaller property investors and could offer the long-term tenancies required for this model. Individual investors could enter and exit from an REIT without disrupting long-term tenancies.

For REITs to be viable in New Zealand, they would need equivalent or preferable tax treatment to small-scale property investors to ensure risk-appropriate returns competitive with other investments.

The research discussed here is part of the BRANZ research programme 'Exceeding the minimum'. It aims to identify barriers to an improved rental stock and find potential solutions. For more information, see Curtis, M. & Brunsdon, N. (2018). *Building to rent*. BRANZ Study Report SR390. Judgeford, New Zealand: BRANZ Ltd.