Chapter 62
Australian Institutional Investors and Residential Investment Vehicles

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Abstract A lack of institutional investor involvement in the private rental residential sector is a structural weakness in the Australian housing rental market. To encourage institutional investment in the private rental market, several residential investment vehicles such as REITs have been introduced in the US and internationally. Despite Australian REITs being the second largest REIT market in the world, no residential REIT vehicle is available in Australia. Therefore, it is not only essential to assess the attitudes of Australian institutional investors regarding housing investment, but also residential investment vehicles. A survey of Australian institutional investors concerning residential property investment was conducted in August-September 2014. The results showed that the lack of well-structured residential investment vehicles and low returns were seen as critical issues in the residential property market. In addition, the most desirable features for an effective residential investment vehicle were being managed by an experienced manager, a diversified portfolio by location and delivering stable income returns with low debt. The implications of the findings are also discussed.

Keywords REITs · Unlisted residential funds · Private rental market · Residential investment vehicles · Institutional investment and Australia

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62.1 Introduction

A clear decrease in housing affordability among Australians has been observed in recent years [18]. The recent report from the Council of Australian Governments confirmed that only a relatively small proportion of homes sold were actually affordable to low-income households [7]. With increasing housing stress in the home purchase market and a limited supply of housing, many potential home purchasers have to seek private rental accommodation. This also pushed up the demand for private market properties [2, 27]. The demand for private rental properties has increased significantly in recent years. In 2014, it was estimated that the Australian private rental market included 2.4 million rental dwellings with 6 million residents across Australia [1]. In 2011–2012, almost 25 % of Australian households rented privately [1]. More importantly, the market grew by 11 % over 2001–2006 [26]. These figures have clearly demonstrated the significant role of the private rental market in the Australian housing sector. To meet the demand of private rental properties, institutional investments in the residential sector would play a critical role in enhancing the supply of rental properties [21].

However, the lack of institutional investor involvement is a structural weakness in the Australian residential rental market, which is dominated by small and individual investors [5, 20, 21, 25, 27]. Indeed, the majority of rental stock in Australia is owned by individual investors over many decades. This is further confirmed by the low level of market share concentration in this market in which the largest four residential operators (e.g. Defence Housing Australia) only account for 5 % of market share [12]. One of the reasons of the lack of institutional investor involvement in this sector can be attributed to the absence of an effective residential investment vehicle. To encourage institutional investment (e.g.: key pension funds) in the private rental market, several residential investment vehicles have been launched in the United States (US) and internationally. In the US, residential real estate investment trusts (REITs) have been introduced. As at June 2014, there were 16 US residential REITs accounting for $95 billion (A$102 billion) in market cap. This sees residential REITs as the second largest REIT sub-sector, being 15 % of the US REIT market [23]. These residential REITs predominantly invest in apartments, with a focus on mobile, affluent markets and growth cities. As well as apartments, some US residential REITs invest in student accommodation and manufactured homes [24]. Importantly, US residential REITs have also significantly enhanced the supply of privately rented properties in which US residential REITs own and manage over 2,300 residential properties with over 644,000 apartment units [23]. Residential investment vehicles have also been successfully introduced in Canada, Japan, Singapore and France. There were 12 residential REITs in the above mentioned markets with a total market capitalisation of A$23.2 billion at June 2014. These 12 residential REITs have nearly 187,000 residential units [4, 11].

Despite Australian REITs being the second largest REIT market in the world (only exceeded by US REITs) [17], no residential REIT vehicles are available in

Australia. Therefore, it is not only essential to assess the attitudes of Australian institutional investors regarding housing investment, but also suitable residential investment vehicles. A large number of papers have examined institutional investment in the residential property sector. That literature, which is reviewed in the literature section, has largely considered institutional investors' attitudes towards residential property investment. No study has been undertaken to examine institutional investors' attitudes regarding residential investment vehicles. More specifically, the important features of an effective residential investment vehicle have not been identified.

Therefore, this study aims to fill in this gap in the literature by examining a number of key elements concerning institutional investment in the private rental residential market. More specifically, it assesses the attitudes of Australian institutional investors concerning residential property investment in general, and residential investment vehicles in particular. This study contributes to the literature in a number of ways. Firstly, this is the first study to investigate institutional investors' perceptions regarding residential investment vehicles. This study not only provides some insights into the perceptions of institutional investment towards residential investment, but also residential investment vehicles. This will assist policy makers and property fund managers to develop an effective residential investment vehicle. More importantly, an effective residential investment vehicle is essential to encourage institutional investment in housing, in light of Australian institutional investors normally not investing directly in acquiring their own property assets [3]. Therefore, an effective residential investment vehicle could enhance the involvement of institutional investors such as Australian superannuation funds in the private rental residential sector. Secondly, the extent of institutional investment in the Australian housing sector is also gauged for the first time. The findings will be of great interest to policy makers and researchers. Specifically, this would enable policy makers to access better informed and robust findings on the institutional investment in the privately rented sector. In turn, an enhanced policy can be formulated to encourage an increased level of institutional involvement in this important property sector.

The remainder of this paper is organized as follows. The following section provides a literature review on institutional investment in housing markets. Section 62.3 discusses the methodology and data. Section 62.4 investigates institutional investors' attitudes regarding residential investment vehicles via a survey. The important features of an effective residential investment vehicle are also identified. The final section provides concluding comments.

62.2 Literature Review

The role of institutional investors in housing markets has been intensely debated in the housing literature. In general, most studies confirm that the level of institutional investment in residential property is marginal. Numerous previous studies have attempted to examine institutional investors' attitudes towards residential property investment. A UK study reported that many institutional investors in the UK considered that, in principle, private renting ought to be an attractive investment [8]. Nevertheless, they were very reluctant to enter into the private rental market for a wide range of reasons, such as small lot size of investment, poor and greater costs of housing management than commercial property, illiquidity, low volatility of rent, low returns, companies' images and other factors. These difficulties see the private rented sector as a much more risky investment sector compared with commercial property (e.g.: office, retail, residential). Consequently, a higher rate of return is required by institutional investors as a compensation for the perceived higher risk level of the private rented sector. Comparable findings have also exhibited by several studies [6, 10, 14, 15, 21] in which low rental yield, high taxes, poor liquidity, higher investment risk, reputational risk, management issues, a lack of sufficient scale, the dearth of market information, poor housing management and political risk have been widely recognised as the key obstacles for institutional investing in residential properties.

Recently, a study has re-examined these issues and identified the barriers of Australian institutional investors to invest in residential properties [21]. It identified five key outstanding deterrents based on the recent experience of institutional investors. These factors are the high risk profile of residential property, track records of property managers, scale of investment in residential property, liquidity of housing investment and political risk. In the UK, a survey of 48 institutional investors also identified the obstacles for investing in residential properties [13]. Low income yield has been cited as the most important barrier for UK institutional investors to invest in residential property. Other critical deterrents are insufficient market size, lack of liquidity, reputational risk, management issues, lack of sufficient scale and political risk. Interestingly, Housing Investment Trusts had been suggested as an important potential vehicle for attracting large scale institutional investment into private renting [10]. To encourage institutional investment in private rented housing, the lack of suitable residential investment vehicles appear as the key important investment barrier [9]. More recently, real estate investment trusts (REITs), a tax transparent investment vehicle, have been seen as an effective vehicle to encourage institutional investors to invest in residential properties [21]. However, a survey of institutional investors' attitudes towards residential property as an investment vehicle in Switzerland, the Netherlands and Sweden also found that institutional investors in these countries invest in residential property directly [22]. The study also suggested that institutional investors' exposure to indirect residential property investment is minor. This refutes the view of the absence of an indirect investment vehicle in housing is a major obstacle to institutional investment in the private rented sector. In addition, a recent survey also showed that, in the UK, direct ownership remains the most popular method of holding residential property by institutional investors, representing almost 60 % of all residential asset value [13]. Listed property companies have not been seen as a good strategy by UK institutional investors to gain exposure in residential property. The principal rationale for investing in residential property is the returns profile. Although the abovementioned studies found that Swiss, Dutch, Swedish and UK institutional investors may prefer to invest in residential properties via direct ownership compared with indirect ownership, this could be attributed to the lack of an appropriate residential investment vehicle in these markets. In these markets, listed property companies are the major indirect property players. Importantly, listed property companies are mainly engaging in property development activities instead of managing rental properties. Therefore, these may not suit the needs of institutional investors who would only like to invest in the residential rental properties market. Conversely, in the US, residential REITs have been recognised as successful investment vehicles. In addition, Australian institutional investors such as superannuation funds do not typically invest directly in acquiring their own property assets. Therefore, an effective residential investment vehicle could be seen as the important strategy to boost institutional investment in this important sector.

Overall, institutional investors do not play a significant role in residential property investment. Residential investment vehicles have been argued as an appropriate vehicle to encourage institutional investment in housing. As can be seen, no papers have as yet considered the desirable features for an effective residential investment vehicle.

62.3 Data and Methodology

To assess Australian institutional investors' attitudes regarding residential property investment, a survey of Australian institutional investors was conducted in August-September 2014. A questionnaire was designed to examine the perceptions of institutional investors towards residential property investment [22]. More specifically, desirable features for effective residential investment vehicles were also surveyed. There were 61 superannuation funds identified from the Australian Prudential Regulation Authority. Superannuation funds were selected on the basis of specific property or CIO in house still being available, rather than those superannuation funds that relied heavily on asset consultants. 23 property investment companies were identified from the 2014 Australian Property Funds Industry Survey that was published by Property Investment Research. These 23 property investment companies are key property investors. Smaller funds with residential property investment were also included in this survey. In total, 84 surveys were distributed.

With 26 respondents, this saw a survey response rate of 31 %, comprising superannuation funds (62 %) and property investment companies (35 %). The total value of the respondents' portfolio was $147 billion, comprising superannuation funds (A$136 billion) and property investment companies (A$11 billion). A wide range of AUM values for these superannuation funds, with an average AUM of A $8.5 billion, up to A$29 billion for the largest superannuation fund has been evident. The total value of the respondents' property portfolio was A$25 billion, comprising superannuation funds (A$13 billion) and property investment companies (A$11 billion). This saw a wide range of property AUM values for these superannuation funds, ranging from A$65 million to A$3.3 billion, with the average property AUM being A$827 million. This sees the respondent superannuation fund profile matching the typical 5–10 % allocation to property seen for Australian superannuation funds and in most mature markets. The average property AUM for the property investment companies was A$931 million, ranging from A$180 million to $3 billion. Survey respondents were at senior executive levels and had considerable experience in the property industry. For the superannuation funds, it was an average of 14 years experience and for the property investment companies, it was an average of 24 years experience. Both the significant AUM of the respondents and their significant experience in property further add credence to the integrity and rigor of the survey responses. The survey questions were largely based on a previous survey for European institutional investors in residential property [22]; with the questions varied to account to local differences. The specific information received in the survey related to:

1. Factual information concerning their portfolios
2. Rating the importance of specific factors; this was done using a 5-point rating scale comprising "unimportant = 1", "less important = 2", "important = 3", "very important = 4" and "critical = 5".
3. Questionnaires were sent to respondents who are at the level of "Managing Director" or "General Manager" or "Fund Manager" or "Chief Investment Officer". This approach was designed to benefit the study by ensuring a high level of reliability. In addition, the respondents have daily exposure to the fund's management, decision-making process, portfolio management and performance measurement.

The survey results are analysed with frequency analysis. Importantly, a survey has been viewed as the effective way to assess the perceptions of human and have been widely used to gauge property investors' perceptions in the property literature [16, 19, 22, 26].

62.4 Results and Discussion

62.4.1 Current Property Types in Portfolio

Retail property (96 % of respondents), office property (92 %) and industrial property (88 %) were seen as the most popular property sectors in the Australian institutional investor property portfolios. Lesser emphasis was seen for the land (42 %) and hotel/motel (19 %) sectors. Residential property was only seen to be in the portfolio of 8 % of institutional investors; this represented only two of the responding funds.

62.4.2 Factors Influencing the Decision to Invest in Residential Property

The importance of the various factors influencing an institutional investor's decision to invest in residential property is shown in Table 62.1. This section was completed by all funds surveyed (# = 26), not just those with residential property in their portfolios. The main factors influencing their decision to invest in residential property were seen to be total expected return (4.27 out of 5), potential for capital appreciation (3.88), cash flow (3.73), risk diversification (3.42) and inflation hedging (3.08). These factors reflect the importance attached by funds to performance analysis and how an asset contributes to the overall portfolio. In particular, these factors rated more highly than the more qualitative factors such as tax benefits (2.62), socially responsible investment (2.38), matching liabilities (2.38) and government subsidies (2.15). This is further emphasized in 85 % of respondents seeing total expected return as "critical/very important", with 62 % seeing cash flow as "critical/very important".

62.4.3 Issues Relating to Residential Property Investment

Table 62.2 indicates the importance of specific issues relating to residential property investment by institutional investors. All specific issues rated highly, particularly the lack of well-structured residential investment vehicles (4 out of 5), low returns (3.84), lack of management expertise (3.72) and poor market information (3.52). The focus on lack of well-structured residential investment vehicles and low returns are fundamentally important to institutional investors and highlight their reluctance to see residential property as a key ingredient in their property portfolios. This is

Table 62.1 Importance of factors influencing an institutional investor's decision to invest in residential property

Factor	Average score	Critical/very important (%)
Total expected return	4.27	85
Cash flow	3.73	62
Potential for capital appreciation	3.88	58
Risk diversification	3.42	50
Inflation hedging	3.08	31
Portfolio regulations	2.92	8
Lack of other investment opportunities	2.50	15
Socially responsible investment	2.38	15
Tax benefits	2.62	12
Other government subsidies	2.15	15
Match against liabilities	2.38	15

Table 62.2 Importance of residential private rented sector investment issues

Issue	Average score	Critical/very important (%)
Lack of well-structured residential investment vehicles	4.00	77
Low returns	3.84	69
Lack of management expertise	3.72	58
Poor market information	3.52	54
Poor liquidity	3.51	54
Rent control	3.48	46
Small lot size and poor quality	3.44	50
Tenancy regulation	3.36	50

further highlighted where 77 % of institutional investors saw the issue of the lack of well-structured residential investment vehicles as "critical/very important" and 69 % of respondents saw the issue of low returns as "critical/very important"; with lower levels of "critical/very important" evident for the other issues relating to residential property investment by institutional investors. This has also been emphasized in previous studies regarding residential property in an institutional investor's portfolio.

62.4.4 *Desirable Features for Effective Residential Investment Vehicles*

77 % of institutional investors considered that a well-structured residential investment vehicle would encourage institutional investment in the residential private rented sector. Given the importance attached to the issue of the lack of well-structured residential investment vehicles, Table 62.3 indicates the importance of desirable characteristics for an effective residential investment vehicle. Top priority is given to the investment vehicle needing to be managed by an experienced manager (4.35/5), followed by diversified portfolio by location (3.92) and focus on delivering a stable income stream (3.88). This clearly reflects the "people" dimension to property funds management and the key role of the fund manager, suitable risk management strategies (i.e. diversification by location) and the importance of income returns. This is further highlighted with 92 %, 81 % and 69 % of respondents respectively seeing these three desirable features as being "critical/very important". Other desirable characteristics seen as being of much less importance included diversification by property type (i.e.: various residential sub-sectors) (3.27), investing in social housing/affordable housing (2.35) or top-end residential properties (2.04) and the need for liquidity by listing on the stock market

Table 62.3 Importance of desirable characteristics for an effective residential investment vehicle

Characteristics	Average score	Critical/very important (%)
Managed by an experienced manager	4.35	92
Diversified portfolio by location	3.92	81
Focused on delivering a stable income stream	3.88	69
Low gearing level (debt usage)	3.31	46
Minimize volatility of portfolio returns	3.38	42
Large scale size	3.42	46
Focus on maximising capital gains	3.58	50
Diversified portfolio by property types	3.27	35
Investing in social housing and/or affordable housing	2.35	15
Investing in middle-end residential properties	2.60	12
Investing in top-end residential properties	2.04	0
Listed on stock exchange (liquid asset)	2.15	12

(e.g.: REIT) (2.15). This highlights the focus on unlisted property investment vehicles for institutional investors to achieve their residential property exposure.

62.4.5 *Potential Problems of Investing in Residential Investment Vehicles*

Whilst recognizing the desirable characteristics needed for residential investment vehicles, the institutional investors also recognized the potential problems with investing in residential investment vehicles. Table 62.4 indicates the importance attached to these potential problems. The most significant potential problems were

Table 62.4 Potential problems of investing in residential investment vehicles

Problem	Average score	Critical/very important (%)
Low returns	4.15	77
Poor market information	3.73	69
Low quality portfolios	3.77	65
Poor liquidity	3.38	54
Regulatory restrictions	3.31	54
Resistance from the board of directors	3.04	31
Not considered as a popular investment vehicle	2.77	27

seen to be low returns (4.15/5), low quality portfolios (3.77) and poor market information (3.73). These are clearly important issues, as seen with 77 %, 65 % and 69 % respectively seen as "critical/very important" by the superannuation funds. These problems clearly relate to property portfolio quality and property information issues, rather than the broader external and internal factors of regulatory restrictions (3.31) and resistance from the Board of Directors (3.04), or not being considered as a popular investment vehicle (2.77) for institutional investors.

62.5 Concluding Comments

While Australian superannuation funds have significant commercial property portfolios, the typical lack of exposure to residential investment by Australian superannuation funds in their property portfolios is highlighted. Thus, this study aims to examine the attitudes of institutional investors in relation to residential property investment in general and residential property investment vehicle in particular. A survey of Australian institutional investors regarding residential property investment was conducted. There are several important findings from this study. Firstly, critical factors influencing Australian institutional investors' decision to invest in residential property have been identified. Return and risk of housing and portfolio considerations have been seen as critical factors. In addition, over 75 % of institutional investors agreed that a well-structured residential investment vehicle would increase institutional investor interest in residential property investment. Secondly, the most desirable features for an effective residential investment vehicle were being managed by an experienced manager, a diversified portfolio by location and delivering stable income returns with low debt. Lastly, institutional investors acknowledged that low returns, poor market information and low quality portfolios are the potential problems with residential property investment vehicles. In particular, the results presented a range of significant challenges and opportunities if we are to see increased levels of residential property in Australian institutional investor property portfolios in the future. Clearly, establishing a well-structured residential investment vehicle is an essential step to enhance institutional investment in residential properties. Ongoing research is required to identify enabling strategies that can be used to increase the level of residential property in Australian institutional investor portfolios. The finding is not only critical for Australian policy makers, but also international policy makers, including Chinese policy makers to enhance the institutional investment in residential property and enhance the supply of rental properties.

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