REIMAGINING THE ECONOMICS OF PUBLIC HOUSING AT WATERLOO

A report for Shelter NSW

Cameron K. Murray and Peter Phibbs

November 2021

Dr Cameron Murray is a Research Fellow at the Henry Halloran Trust at the University of Sydney.

Professor Peter Phibbs was the Founding Director of the Henry Halloran Trust and is now an Emeritus Professor at the University of Sydney.

SUMMARY

The physical design of New South Wales (NSW) Land and Housing Corporation's (LAHC) proposed redevelopment of Sydney's Waterloo Estate has been reviewed and reworked by various stakeholders to reimagine a better urban design outcome.

This report does a similar exercise for the economic and financial designs of this project, and public housing generally. Our question is, are there economic designs that can improve the long-term public housing outcomes from redeveloping the Waterloo estate?

To date, investment in new public housing has been considered as a cost only. But housing (even public housing) is an asset that generates a return over time in the form of rental income and capital gains. Ignoring these asset returns is a key economic issue with the LAHC self-fund development model. Indeed, applying this model while ignoring asset returns is self-limiting; it privatises long-term returns on real estate assets, which are the source of value that funds public housing redevelopment.

If the NSW Government wishes to maximise long-term public housing provision, they should consider more elegant economic and financial designs. This would include mimicking private sector behaviour, such as using leverage during redevelopment periods, retaining market risk and return during the development process, and retaining long-term ownership of as much of the real estate asset base as possible. Doing so would also provide the flexibility to vary future redevelopment stages to accommodate changing housing policy needs.

One alternative this research explores is a model whereby 50% of new dwellings are public housing, 25% are retained by LAHC as build-to-rent housing at market prices, and 25% are sold by LAHC to the private market. This scenario uses low-cost leverage to generate positive cashflow, and maximises exposure to long-term capital gains for LAHC.

BRIEF

Waterloo South is a 10.8Ha precinct in Sydney owned by NSW Land and Housing Corporation (LAHC). It currently has approximately 1,000 public housing residents[1] in 749 public housing units that were built throughout the 1960s and 1970s.

The current market value of the site is estimated to be around $1 billion (in the range of $750 million to $1.6 billion).[2] The site forms part of LAHC's $54 billion net asset portfolio (as of 2019), which grew from $32 billion over the prior seven years, reflecting a 7.8% annual growth rate.[3] For comparison, this property portfolio is five times larger than the market capitalisation of the largest listed developer, Stockland, and nine times larger than major developer Lendlease.

Redevelopment of this precinct is being proposed as part of LAHC's remit to self-fund expansion and upgrade of public housing stock via the redevelopment of their valuable real estate assets. This typically involves contracting a private development company to supply new public housing dwellings in return for the opportunity to develop private housing on the site.

LAHC and the City of Sydney have each proposed alternative development designs for the Waterloo South precinct. Discussion and review of these alternative design options, along with a newly established assessment process focused on the merits of the design, is likely to deliver a quality urban design outcome.

But there are also many alternative economic and financial designs for the project which have not been fully explored. This report provides an economic background as to how best to assess such alternatives. It also offers some implementation ideas that might improve public returns and the size of the public housing stock being delivered long term.

---

[1] Basic data such as public housing occupancy is not readily available, though it has been reported that as many as 1,100 public housing tenants occupy existing dwellings in the Waterloo Estate.

https://www.abc.net.au/news/2019-01-25/New South Wales-government-housing-plan-for-sydney-suburb-of-waterloo/10749420

[2] The indicative value of the property right per apartment for high-density residential development sites in the inner suburbs of Sydney was $200,000 to $600,000 per apartment in 2018 but fell slightly during 2020 to $180,000 to $550,000 per apartment. There are 3,000 new apartments proposed in both alternative plans for this site. See https://content.knightfrank.com/research/910/documents/en/sydney-apartments-development-series-h1-2019-6403.pdf and https://content.knightfrank.com/research/910/documents/en/sydney-apartment-projects-review-2021-8148.pdf

[3] Based on assets identified in the 2011-12 LAHC Annual Report and 2018-19 Family and Community Services Annual Report.

BACKGROUND

LAHC is a self-funded public trading enterprise. It earns revenue primarily from rents and tenant charges (around $800 million per year), and government grants (around $150 million per year). Its costs are mainly housing repairs (around $300 million), rates (around $130 million), tenancy management (around $100 million) and personnel (around $70 million). It has a positive net cash flow on its operational activities of around $80 million.[4] It has a broad remit, including managing public housing tenancies, sale and purchase of dwellings and development sites, and managing housing subsidy schemes.

The redevelopment of the Waterloo South site has been part of a political discussion for decades and was formally announced in 2017.[5] LAHC's current proposed economic design under its 'Communities Plus' model involves selling portions of the site to private developers. Instead of payment (solely) in cash, the private developer-partner builds new public housing for LAHC. This reflects LAHC's self-funding model of development—selling LAHC owned property assets to pay for new public housing construction.

LAHC's Waterloo South proposal contains 70% private housing, to be owned by the private developer-partner, and 30% public and affordable housing. Out of that 30%, 5% will be allocated to a Community Housing Provider (CHP) who will supply rental properties at 20% below-market rates. The remaining 25% of the 3,050 proposed dwellings are public housing. The developers of the private dwellings will construct new public housing dwellings in lieu of paying for land ownership. Physically, LAHC's proposal has a podium and high-rise design and additional open spaces.

The City of Sydney produced an alternative redevelopment design of mostly low and mid-rise buildings (with the same number of total dwellings). In addition to physical changes, Council proposed a project with 30% public housing, 20% for CHPs, and 50% private dwellings. As well as being a major departure from LAHC's design, the City of Sydney also proposed a quite different dwelling mix. A comparison of the current site use and these two alternative proposals is highlighted in Table 1.

Table 1: Summary of Waterloo South redevelopment alternatives

	Current	*LAHC proposal*	*City of Sydney proposal*
Private dwellings	125 (14%)	2,135 (70%)	1,525 (50%)
Public dwellings	749 (86%)	762 (25%)	915 (30%)
Affordable (CHP) dwellings	0	153 (5%)	610 (20%)
Total dwellings	874	3,050	3,050
Building heights	Low and high-rise	Mid and high-rise	Low and mid-rise
Bedrooms per dwelling (av.)	2.07	Unknown	Unknown

Source: Independent Advisory Group (IAG) Waterloo South Report. May 2021.

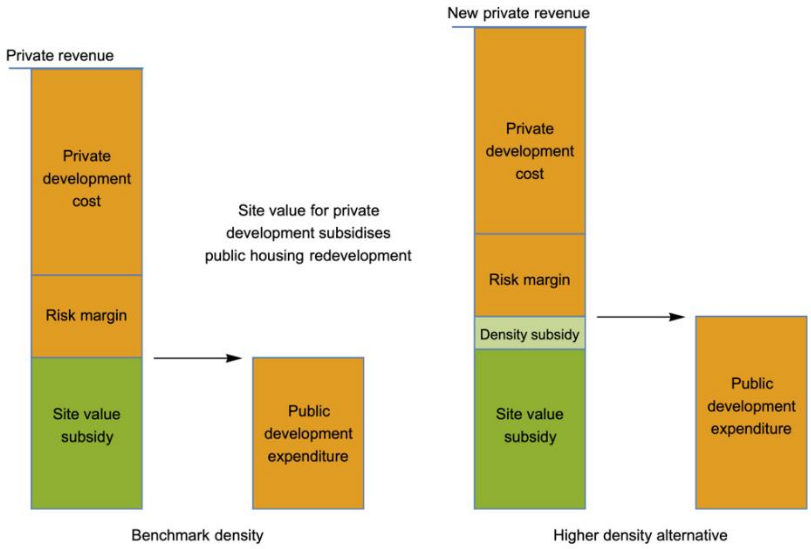
LAHC's proposal notably results in only 13 additional public housing dwellings on the site (762 compared to 749), and 153 new affordable housing units. By contrast, the City of Sydney proposal generates 166 additional public housing units and 610 affordable housing units. If LAHC's proposal generates additional cash revenue that can be spent at other locations to expand the public housing stock, there may be more merit to their

[4] Department of Planning, Industry and Environment Annual Report 2019–20 https://www.opengov.nsw.gov.au/publications/19104

[5] https://www.planning.nsw.gov.au/News/2017/Waterloo-nominated-as-next-state-significant-precinct

proposal. But at face value, the LAHC proposal seems to offer surprisingly little public value in the form of an expanded public housing stock.

Figure 1: The right to develop more private dwellings is a "self-fund subsidy"



One way to generate more self-funded public housing at Waterloo South is to increase the density of the redevelopment. Figure 1 shows how higher density development increases public returns compared to a benchmark case. The left column represents the revenue from the sale of private dwellings on the site. A large portion of this revenue is used to pay for private development costs, and a margin is deducted to account for risk. The residual site value (revenue minus costs) is converted into a "self-fund subsidy" for public development expenditure (second column).

Increasing the amount of private housing on the site by increasing overall density generates more private revenue, increasing the residual site value (third column) and therefore creating an additional subsidy for public housing.

While increasing private housing density certainly can increase the value of the self-fund public housing subsidy, this report does not assess its merits for three reasons.

Firstly, quality urban design has a public good component. It has a value that should be factored into project deliberations. Ideally, a desirable urban design is first determined, then an economic design is applied to maximise public housing expansion on the project site or elsewhere.

Secondly, a change in planning controls to allow more dwellings is merely a non-cash form of subsidy from the NSW Government. The Government could instead sell the right to build at higher densities to a private owner. Selling such rights is equivalent to any other budgetary revenue.

Thirdly, this approach fundamentally ignores the key issue at stake — housing is an asset that generates returns over time and costs should not be considered in isolation from these returns. A proper evaluation of asset investments requires assessing risks and returns, not just costs.

The remainder of this report explores the implications of housing as an asset, not a cost, in the context of the Waterloo South project and the long-term economic design of public housing investment in NSW. It finishes with a suite of ideas for economic and institutional design to grow public housing stock more quickly than is possible in the current self-limiting self-fund model.

ECONOMIC CONSIDERATIONS

The total stock of Australian housing grew in value from $8 trillion to $9 trillion in the first half of 2021.[6] This $1 trillion value gain represents approximately $100,000 per household. In addition, Australian renters paid $40 billion in rent in 2020-21 and homeowners gained $100 billion in value from their occupancy.[7]

Housing assets earn a return via rental income and capital gains. This is why private investors, and a growing corporate build-to-rent sector, find building new housing an attractive long run investment option. For example, offshore institutional funding accounts for 57% of Australia's private build-to-rent pipeline.[8] Australia's first build-to-rent project, the Smith Collective on the Gold Coast, was seen as a worthy investment for a foreign government investment fund that financed the $500 million project.[9]

PUBLIC HOUSING ASSETS IN CONTEXT

Public housing has been an investment success across Australia and in NSW. Investments from decades ago have created a $54 billion public asset base held by LAHC for the NSW Government.[10] This has happened while public housing has also provided essential subsidised housing for hundreds of thousands of NSW citizens. Unlike most other Government spending, public housing generates an economic return to the Government in addition to the direct housing policy outcomes.

These economic returns are evident in the value of LAHC's property portfolio, which increased from $32 billion in 2012 to $51 billion in 2020, a 7.8% compound return. LAHC also makes around $800 million per year in rental income from its property portfolio.[11] LAHC's balance sheet is larger than any of Australia's largest private housing developers (see Figure 2). This enables it to carry financial risk at low cost. However, unlike other development companies, it does not borrow extensively in the capital markets to leverage this return on its property portfolio, nor to fund new housing or redevelopment projects.

Lendlease, for example, reported around $8.5 billion in property value on its balance sheet and borrowings in the form of corporate bonds and bank credit of $2.5 billion, while Stockland reported $15.4 billion of property assets and $4.6 billion of borrowing. LAHC's comparatively large property portfolio and absence of leverage is clearly shown in Figure 2. Had LAHC leveraged in a similar manner to private developers and property asset portfolio managers, their asset returns over the past decade would have been substantially amplified.

---

[6] Corelogic. 2021. Australian housing market surpasses $9 trillion valuation. 7 October 2021. https://www.corelogic.com.au/news/australian-housing-market-surpasses-9-trillion-valuation

[7] ABS national accounts.

[8] CBRE. 2021. Australia ViewPoint BTR Development Pipeline 2021 February. https://www.cbre.com.au/research-reports/Australia-ViewPoint-BTR-Development-Pipeline-2021

[9] Cranston, M. 2014. Abu Dhabi at the Gold Cost. AFR. https://www.afr.com/companies/infrastructure/abu-dhabi-at-the-gold-coast-20141104-11gefg

[10] Based on assets identified in the 2011-12 LAHC Annual Report and Department of Planning, Industry and Environment Annual Report 2019–20.

[11] Ibid.

Figure 2: LAHC property assets/borrowings vs private property companies [12]

SELF-FUNDING IS SELF-LIMITING

A political intent to limit public investment is expressed in the NSW Government's "asset recycling" approach to property management.[13] This term simply means that new public assets are paid for with the proceeds from selling existing public assets. Unless the public sector has hidden information about the performance of assets which they are trading and that allow them to beat the market, this is a self-limiting approach to public asset investment.

Asset recycling, or self-funding, means that the LAHC sells assets generating high capital gains but low occupancy benefits, in the form of well-located public land and housing, to fund new housing assets that have higher occupancy returns.

This is an economically unusual situation, as the NSW Government can borrow for any purpose at an interest rate of 1.5%.[14] Instead of selling relatively high return real estate assets to fund new public housing, the NSW Government and LAHC could sell low return bonds to increase overall property portfolio returns, just like private property investors.

We can see the limits of this model by considering a hypothetical scenario where a new public housing agency is created at a place or time when there are zero public housing dwellings. Under a self-fund model, there are always zero dwellings. This approach cannot expand public housing. It can only swap real estate assets already

[12] Stockland. 2021. Annual report 2020-21 https://www.stockland.com.au/~/media/corporate/investor-centre/fy21/annual-results/fy21-stockland-annual-report.ashx?la=en and Lendlease. 2021. Annual report 2020-21. https://company-announcements.afr.com/asx/llc/d5187c65-fe15-11eb-b21a-c297ef9c89b1.pdf and Mirvac Annual report 2020-21. https://mirvac-cdn-prd.azureedge.net/-/media/Project/Mirvac/Corporate/Main-Site/Corporate-Theme/images/Investor-Centre/Annual-Report/MGR_FY21_AR_Interactive.pdf

[13] Property NSW. 2016. Asset Recycling Insight Report. https://www.dpie.nsw.gov.au/__data/assets/pdf_file/0004/324859/Asset-recycling-insight-report.pdf

[14] RBA. 2021. Table F2.1 Capital market yields—government bonds. https://www.rba.gov.au/statistics/tables/xls/f02hist.xls

owned by the Government, in the process selling appreciating assets (land) to build depreciating ones (dwellings).

Self-funding is another word for subsidising with assets accounted for on LAHC's balance sheet rather than elsewhere on the NSW Government's balance sheet.

Table 1: Case Study, Millers Point

Millers Point — A rush to privatise real estate gains meant that the taxpayers lost out and vulnerable tenants were evicted

The sale of 296 public housing units in and around Millers Point was announced in March 2014. It was estimated that the sale of the 296 properties in this high value area would generate $500 million of revenue over a two-year sales process. For a variety of reasons, including community resistance, the sales were delayed and were not finalised until 2019. The sales ultimately generated $762 million (including the Sirius building). This $262 million increase was the gain to LAHC from the continuing appreciation of Sydney residential property rather than relying on the original expedited sales process.

Many community groups proposed selling vacant dwellings in Millers Point and dwellings of tenants who volunteered to leave, whilst allowing social housing tenants to age in place and sell dwellings only when tenants died or moved into permanent care.[15] This would have been a more socially responsive policy, especially given that in 2013 more than 43% of the tenants were 60 or older.[16] With continued gains in Sydney property values, this approach could have vastly increased the economic return to LAHC while providing stability to public housing residents. This demonstrates the self-limiting nature of the self-fund model, which relies on selling high-return assets as the funding source for public housing investment. Whilst the sales from Millers Point provided the revenue for much needed new Social Housing, if this housing was funded using debt financing—available at a 2 per cent interest rate to the NSW Government, and Millers Point Tenants allowed to age in place, this would have pushed sales into the current housing boom, improving the returns to the NSW taxpayer whilst vastly improving the social outcomes for tenants[17].

RISK AT THE TIME OF REDEVELOPMENT

The NSW Government has owned the Waterloo South site for half a century. Over this long period, it has held the risk associated with the asset and benefited from the returns associated with those risks.

Under the self-fund approach to new public housing investment, LAHC will privatise a substantial portion of the risk (and therefore return) of this asset that arises during the redevelopment process. Risks associated with construction cost, time, and market price variation, are factored into the required margins of private developers. This in turn reduces what they can reliably contribute to public housing construction. It is not clear why this risk cannot be retained by LAHC, whose balance sheet is far more robust than any private developer. Indeed, the organisational capability for coordinating development exist within the NSW Government at Landcom.

---

[15] Mowbray. R. 2018. The sale of Millers Point has ended: it has made inequality worse. TUNSW. https://www.tenants.org.au/blog/sale-millers-point-properties-has-ended-it-has-made-inequality-worse

[16] Cred Consulting. 2014. Social Impact Assessment of the potential social impacts on the existing Millers Point Community, and the broader social housing system, that may result from the sale of any further social housing in Millers Point. Report to the LAHC.

[17] ibid

As part of this economic assessment, we conducted an indicative feasibility analysis for the private development at Waterloo South based on LAHC's proposal. This assessment indicates the relative size of the required risk margin on the development compared to the residual site value. Doing so demonstrates the opportunities available for LAHC to retain risk and operate as a developer during the redevelopment period in order to increase possible returns.

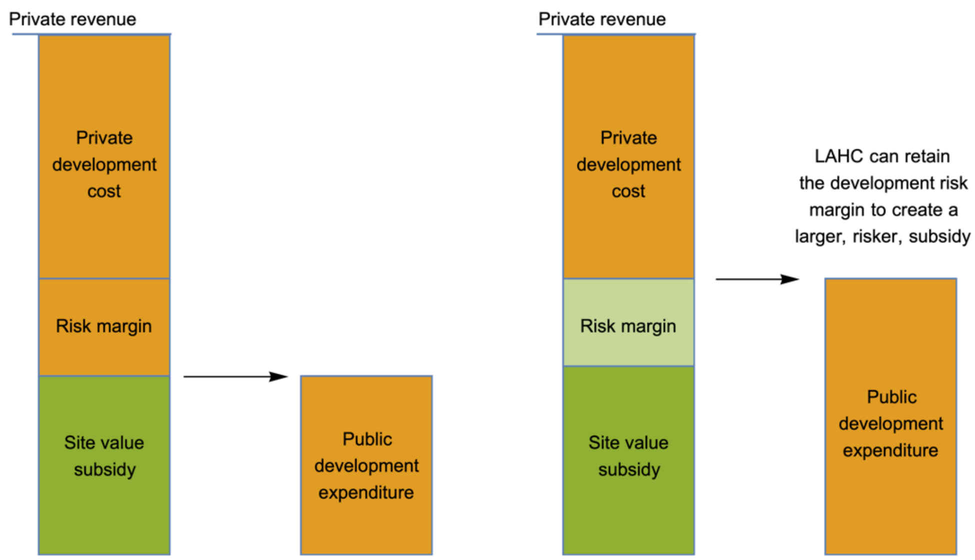
As an initial ballpark figure, the value from building 2,000 private dwellings on the Waterloo south site is roughly $1 billion.[18]

Figure 3 shows a baseline residual value calculation in the left column. The roughly $2.4 billion in private revenue requires spending about $1 billion in development costs. Typically, when a site is purchased with an upfront payment, a risk margin in the order of 20% of revenue is accounted to allow for variation in market prices, sales rates, construction time, and costs. Higher margins are typically applied to larger high-risk projects. For example, a 15% price decline and a 10% construction cost increase would remove all profit on a project with a 20% risk margin and make it an enormous, multi-million-dollar liability.

A 20% risk margin on a project the size of Waterloo South is roughly $460 million. After subtracting a risk margin, developers can then contract to pay the remaining $1 billion towards new public housing, or as a cash site purchase, or any variation of payment.

The final column of Figure 3 shows how, if LAHC instead retains the risk during development, that margin (if realised) can be an additional self-fund subsidy. In relative terms, the margin is nearly half as large as the existing site value subsidy.

Figure 3: Potential for risk margin to be retained at the time of development



[18] These rough figures are based on the following assumptions.
Revenue = 2,000 dwellings x 85sqm x $14,000/sqm = $2.4 billion
Development cost = 2,000 dwellings x 85sqm x $5,500/sqm = $940 million
Risk margin (~20% of revenue) = $460 million
Site value = $1 billion

However, the risk margin cannot be treated as a cash-equivalent subsidy. This margin could ultimately end up being zero, negative, or indeed many multiples larger than that accounted for upfront.

But then again, LAHC already holds this risk by being the Waterloo South site owner. Holding that risk has been extremely profitable for LAHC historically. The benefit to privatising the risk during the redevelopment phase of property ownership is unclear. LAHC's balance sheet is many multiples larger than even the biggest private Australian property developers and hence of all organisations they can best carry such risks.

Politically, LAHC is likely to also retain downside risk because a bankrupt private developer that is unable to complete the project will be politically unpalatable. It seems unlikely that the NSW Government would undertake the legal manoeuvres necessary to send one of Australia's largest property developers broke by forcing them to complete the Waterloo redevelopment if economic conditions deteriorate.

Indeed, the Independent Assessment Group's (IAG) recent review noted how little risk is shifted from LAHC to the private developer-partner under their typical arrangements.

> *The IAG takes the view that the commercial structure of the proposed development is highly attractive to developers, not necessarily because of particularly high levels of profitability but because of the inherent efficiency of the structure and the appropriate allocation of development risks. … The development is not without risk but is a rare opportunity and in all likelihood more attractive than many other competing opportunities.*[19]

LAHC could also carry the risk throughout the project, with contractual arrangements for the delivery of public housing that are conditional on private returns—higher private returns could require more public housing. As a payment for the site is not required upfront, and risks are contractually shared between LAHC and the developer, this arrangement could improve the public benefits from self-funding by attracting developer participation at lower margins. However, arrangements that rely on profit-sharing with private partners to determine public benefits can be difficult to enforce and are often gamed.[20]

Alternatively, LAHC could retain the risk and function as the property developer, contracting private firms only for construction projects in each stage, or engaging the state-owned developer, Landcom. By doing so they would also benefit from the flexibility to vary the design of future stages to accommodate changing market conditions and policy demands.

If the reason for engaging a private developer-partner for LAHC redevelopment projects is less about reducing risk and more about coordinating construction, this function can be undertaken by one of many large builders or specialist firms on a contractual basis.

COMPARISON OF HOUSING ASSET RETURNS

Housing assets of all types can be judged on their long-term returns—cash incomes, public policy benefits, and capital gains. Private, public, and affordable (managed by Community Housing Providers or "CHPs") housing

[19] Independent Advisory Group (IAG) Waterloo South Report (p62). May 2021.

[20] The Barangaroo Delivery Authority profit-share with Lendlease, for example, failed to recoup a share of value gains. https://www.afr.com/property/commercial/lend-lease-wins-1bil-appeal-against-barangaroo-delivery-authority-20140821-jkqd1 Manipulating accounting profits can be done using transfer-pricing, paying bonuses, or other cost-padding.

types that make up the Waterloo South proposal all generate the same total return. However, the way that economic returns are split between asset owner and resident are quite different.

For public housing dwellings, that 8.2% gross return is split quite differently. About 2% goes to tenants in the form of their discounted rent (i.e. they typically pay only a third of the market price, around $125 per week). Ongoing costs are higher in the form of tenancy management, leaving a net return to the dwelling owner (in this case LAHC) of 3.7%.

Table 2 illustrates how dwelling asset returns are shared amongst the alternative housing types, both market and discounted. Based on current gross yields for Sydney dwellings, and historical capital gains, a typical Sydney dwelling has a gross return of 8.2%, though with substantial variability (e.g. returns in 2018 were -4%).

Out of that gross return, the typical private dwelling requires about 2% of the market value for ongoing costs each year, hence delivering a 6.2% annual net return. This is the economic return available to housing investors, including built-to-rent (BTR) institutional investors.

For public housing dwellings, that 8.2% gross return is split quite differently. About 2% goes to tenants in the form of their discounted rent (i.e. they typically pay only a third of the market price, around $125 per week). Ongoing costs are higher in the form of tenancy management, leaving a net return to the dwelling owner (in this case LAHC) of 3.7%.

Table 2: Comparison of housing asset yields

Returns	*Private (e.g. BTR)*	*Public*	*Affordable ("CHP")*
Market gross yield[21]	3.4%	3.4%	3.4%
Capital gain[22]	4.8%	4.8%	4.8%
Gross return	**8.2%**	**8.2%**	**8.2%**
Net tenant subsidy	—	2.0%	0.4%[23]
Ongoing costs[24]	2.0%	2.5%	2.2%
Net return to asset owner	**6.2%**	**3.7%**	**5.6%**
Net return (at half capital gains)	3.8%	1.3%	3.2%

Source: Authors estimates based on noted referenced material

Affordable housing provided by Community Housing Providers (CHPs) at 20% below market rents see some of the return shifted to tenants. But because these tenants are also eligible for Commonwealth Rental Assistance payments (CRA), the return to the dwelling owner is not reduced by the full amount that the tenant gains in

---

[21] SQM Research. 2021. Property gross rental yield—Sydney NSW. https://sqmresearch.com.au/property-rental-yield.php?region=nsw-Sydney&type=c&t=1

[22] Capital gains in Sydney for the past 18 years from ABS. 2021. Residential Property Price Indexes: Eight Capital Cities. https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/residential-property-price-indexes-eight-capital-cities/latest-release

[23] CHPs tenants get below-market rents, but they are also eligible for Commonwealth Rent Assistance (CRA), which is paid to the dwelling owner. Thus, not all of the subsidy to the tenant comes out of the returns of the owner—the gap is made up by the CRA.

[24] A 2% of property value assumption has been used to reflect the holding and management costs. For a $1 million dwelling is $20,000 per year to cover council rates, home insurance, rental management, and other maintenance items.

the form of lower rent. These rough figures suggest that CHP dwellings provide a 5.6% net return to asset owners.

What is noticeable immediately is that all forms of housing generate net returns to asset owners in excess of the cost of borrowing for a public agency, which is currently 1.5% for New South Wales (i.e., the return on government bonds). This means that leverage can work to amplify the returns on any of these three types of housing asset. Unless rates of capital gains fall to half their long-term average, even public housing generates enough of a return to cover the cost of capital.

INTRA-GOVERNMENTAL ACCOUNTING

A final point concerns intra-governmental accounting. There are two related issues. Firstly, any service offered at a below-market price involves a subsidy. The subsidy to public housing tenants in a self-fund model is an accounting trick that hides a subsidy "off book", avoiding being reported in government budgets (which typically do not produce or report balance sheets).

Secondly, given the fixed amount of this hidden subsidy, any additional costs or obligations imposed on LAHC during site redevelopment come at a loss of new public housing. For example, site infrastructure spending for project redevelopment and tenant management and relocation, are costs that private developers would not be obliged to meet, and hence are a form of subsidy hidden on LAHC's financial accounts.

A final conundrum is the way the same spending is called a cost or an investment in a different context. In October 2021, the NSW Government announced a $183 million subsidy for building public housing.[25] This was sold as an investment in housing supply and a boost to construction jobs—implementing a macroeconomic objective to support broader growth.[26] Yet the self-fund model imposed on LAHC limits spending on public housing. If building houses is good for the macroeconomy and investment in the future, why is this not always the case?

---

[25] Bartsch, P. 2021. NSW Social Housing Gets $183m Boost. The Urban Developer. https://www.theurbandeveloper.com/articles/funding-turbocharge-for-social-housing

[26] Kean, M. 2021. Twitter post by NSW Treasurer, Minister for Energy & Environment
, Matt Kean MP 16 Oct 2021. https://twitter.com/Matt_KeanMP/status/1449284384763224064?s=20

ECONOMIC OPTIONS FOR WATERLOO

Taken together, the following factors point to an economic design that can accelerate the expansion of public housing stock compared to the current LAHC self-fund model.

1. The nature of housing as an asset
2. The sizeable balance sheet of LAHC
3. State (via Landcom) capacity for development operations

The focus of these economic design options is to maximise the share of public housing on the Waterloo South site after redevelopment while meeting the self-fund requirement.

LEVERAGED BUILD-TO-RENT (LBTR) SELF-FUND

Because of the low cost of capital for LAHC and their existing site ownership, they have a unique ability to enter the private build-to-rent market as a way of earning ongoing returns to fund public housing. They can also leverage returns.

To provide an indication of how this approach works, Table 3 shows the costs and returns involved for a single BTR dwelling, a single public housing dwelling, and the combined cashflows of two dwellings, one of each type.[27]

Each BTR dwelling at Waterloo can generate roughly $26,000 per year in net cashflow, while each public housing dwelling generates zero, as costs roughly equal the discounted rents paid.

Table 3: Indicative per dwelling returns to LAHC from alternative dwelling types

Returns	*Build-to-rent*	*Public ("social")*	*One-to-one combined*
Market gross rent[28]	$34,000	$8,000	$42,000
Repairs, rates, tenant management[29]	$8,000	$8,000	$16,000
Cashflow	$26,000	—	$26,000
Interest on development cost[30]	$7,200	$7,200	$14,400
Capital gain[31]	$49,200	$49,200	$98,400
Development cost	$480,000	$480,000	$960,000

Source: Authors estimates based on noted referenced material

Bundling together one BTR and one public dwelling provides the same $26,000 net cashflow and comes at a development cost of roughly $960,000. Interest on that combined cost is $14,400 per year, leaving $11,600 per year in net cashflow in the scenario where 100% of development costs are borrowed.

In addition, each dwelling generates capital gains over time, which are a substantial part of the overall return from dwellings in the long run. Applying the historical average capital growth for Sydney suggests that $49,200

27 This represents the one-to-one ratio of public to private housing put forward in the City of Sydney proposal.

28 SQM Research. 2021. Weekly rents. Postcode 2016. https://sqmresearch.com.au/weekly-rents.php?postcode=2016&t=1

29 An allowance for $3,000 for tenant management, $2,500 for repairs, and $2,500 for council rates. The same rate is applied to public housing. LAHC financial accounts show repairs, rates, tenancy management, are slightly less than the net rental income in the existing public housing stock.

30 Interest on $480,000 development cost ($6,000/sqm for 80sqm) at 1.5% interest (NSW 10yr bond rate).

31 Applying the Sydney hedonically adjusted average growth rate since 2003 to current two-bedroom apartment prices of 1,040,000. (See 21)

in capital growth can be expected per year on average. This seems high, however, since the historical growth coincided with an historical once-off adjustment to low interest rates. But even if future capital growth is half this historical rate, it still provides half the total economic returns of dwelling ownership. Retaining ownership of the build-to-rent dwellings provides LAHC with the future flexibility to use these capital gains or otherwise manage their balance sheet (which may be more important if they begin to use leverage).

Table 4 shows the indicative financial outcome for a redevelopment scenario for Waterloo with a dwelling mix of 750 BTR, 750 private sale, and 1,550 public housing dwellings. Under this model LAHC would retain ownership of the BTR dwellings and the public housing dwellings. These figures apply to indicative "standard" two-bedroom dwelling, though some variation in dwelling mix will be necessary to meet demands for BTR, private sale, and public housing demands. Conducting this exercise on standard dwellings merely demonstrates the economic logic of the approach.

In this scenario, the 750 new BTR dwellings would have a development cost of around $360 million ($480,000 per dwelling), generating $20 million in net income before interest. They would also generate capital gains over the long-term, which would suit the long-term objectives of LAHC.

Table 4: LBTR model can achieve 50% public housing

	Build-to-rent	*Public ("social")*	*Private sale*
Number of dwellings	750	1,550	750
Total development cost (m)	$360	$744	$360
Total sale revenue (m)	—	—	$780
Annual net income before interest (m)	$20	—	—
Annual capital gain (m)	$37	$77	—
Net development cost to LAHC (m)	$684		
Net asset value retained (m)	$2,400		
LVR if borrowing net 100% of net costs	28.6%		
Interest on net development cost (m)	$10		
Net income after interest (m)	$9		
Capital gain (m)	$115		

Source: Authors estimates based on noted referenced material from Table 3.

The 1,550 new public housing dwellings would have a development cost of around $744 million, and generate no net income before interest, as management and maintenance costs would be close to as much as the rents paid by public housing tenants. However, these dwellings would provide capital gains to LAHC, and the flexibility at the end of the building life to utilise those gains.

Lastly, the 750 private sale dwellings, will cost $360 million to develop and earn about $780 million in sales revenue. Rather than private sales revenue being used as the sole source of funding, these sales function to reduce leverage across the whole project and facilitate a residential mix within the project area that achieves social aims.

STATE AGENCY AND CHP CAPACITY TO DEVELOP

By operating as a BTR developer and selling into private markets, LAHC will carry additional risk compared to selling the site or contracting out the redevelopment for a fixed public housing outcome (30% based on the current model) with a private developer.

However, privatising this risk will diminish returns. LAHC is most able to manage risk associated with the redevelopment project due to its large unlevered balance sheet. Holding ownership and control during redevelopment also provides LAHC with the flexibility to develop the project in stages and take advantage of changes to planning, market conditions, or policy imperatives. For example, if private market demand falls, LAHC can retain more BTR dwellings and reduce sales until market conditions improve.

The NSW Government has expertise to run development projects within the state-owned corporation Landcom. It may be possible to merge Landcom and LAHC, or to simply have them operate together as they often do, to pool property management and development skills and diversify the operations of each entity.

Further, the growing skill base within CHPs to develop and operate below-market housing is an opportunity available to LAHC to further enhance social outcomes in the form of below-market housing. Retaining greater property ownership provides LAHC with more flexibility to enter arrangements such as long-term leases (say 49 years) with CHPs who can develop and operate housing. This type of approach means that LAHC retains the long-term capital gains associated with the project, again improving long-term economic outcomes for the NSW Government while increasing the stock of subsidised housing.

CONCLUSIONS

This report has shown how the neglected idea that housing is an asset can help reimagine the economic design for public housing. When there is a focus more on the long-term asset returns available, rather than only on the short-term costs during the redevelopment period, public housing outcomes can be greatly enhanced even under the self-fund constraint. Exceeding the self-fund constraint and using cash subsidies in addition to real estate value subsidies could further accelerate the expansion of publicly owned housing.