Purpose-Built Rental and Condo Development: Market Perspectives

Research Report
April 2019

Canadian Centre for Economic Analysis

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OBJECTIVE AND APPROACH

The key objective of this project was to shed light on any systematic or general factors or differences that might dissuade developers from building purpose-built rental (PBR) or incentivize condominium development (condo). This project examines the issues from the view of market participants and the calculus they perform. Areas of interest included inquiry into considerations of:

- Financing, debt and equity;
- Land costs;
- Construction costs;
- Local regulatory approvals processes;
- Rental operational processes;
- Taxation

Under the agreement of anonymity, information was collected by way of interviews with industry professionals which included developers, general contractors, real estate advisors, financiers and private equity funds. Interviews followed a pre-determined structure (Appendix A) that was provided to the participant prior to the interview. In all, seventeen participants contributed to our findings. Participation had a regional bias in that Ontario and Vancouver were the sole source of respondents.

The findings were also fortified by direct observation of regional differences and trends.

RESULTS AT A GLANCE

Through the incremental build-up of regional expertise and activity volume, regional markets have developed their preferred business models and building forms, which have been shaped by:

- Local regulation;
- Past private equity preferences (which are changing) and the institutionalization of debt transactions for particular development types (ability to execute quickly and efficiently);
- Land values, density and real estate price expectations and their relationship to rent expectations;
- Taxation changes; and
- Volatility of policy, costs and land value changes. In volatile markets, either rent controls or the uncertainty of future rent controls can be significant deterrents for PBR investment.

Each element of a pro-forma combines to generate an internal rate of return and cash yield. As such, factors are considered in combination; they cannot be isolated, as one detriment can be offset by another advantage within the pro-forma.

Different factor combinations have created regional variations. For example, Quebec exhibits a bias towards PBR that is, on average, 1.7 times that of Ontario.

While not directly identified by respondents, and not specifically assumed or measured as part of a pro-forma exercise, the perceived volatility of policy, costs and land value changes appears to be a significant factor when comparing the risk-adjusted return of PBR and condos. While sensitivity analyses are performed on key variables of the pro-forma, the risk adjustment to the return is largely performed outside of the pro-forma by providers of capital.

1.0 INVESTMENT CONSIDERATIONS IN CHOOSING PBR OR CONDO DEVELOPMENT

1.1 Risk, Returns and Time Horizons

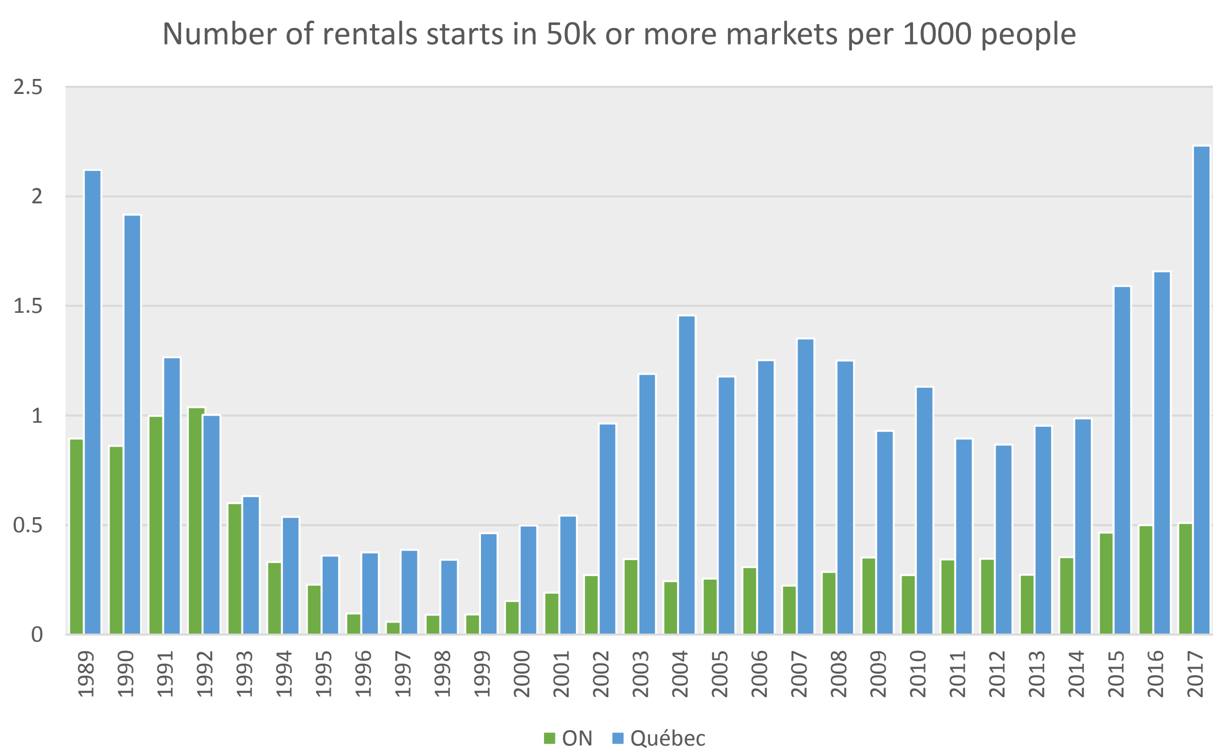
Investors and developers seek the highest rate of return for their chosen investment horizon.

FINDINGS

Regional Differences

There are significant regional differences. It is difficult to generalize a preference for one type of tenure as against another as in some parts of the country, PBR is preferred, while in other parts, the preference is towards condo development. For instance, there is a marked difference between Ontario and Quebec; historical trends show that the number of PBR starts per thousand residents in Quebec is much higher than in Ontario (see Figure 1).

Figure 1 PBR Starts Comparison between Ontario and Quebec



Each element of a pro-forma combines to generate an internal rate of return and cash yield. Regional variations occur for different elements of a pro-forma. For instance, while construction costs per square foot (sqft) are lower for small building forms, the cost of land per sqft may require taller building forms. Regions can differ significantly on the different building forms allowed.

Equity and Financing

Overall, there is no big perceived gap related to equity and financing between PBR and condo development. We find that since the 1990s:

- Shorter investment horizons at higher rates of return have been preferred by investors, leading to an inverse required rate of investment curve (perception of risk of a correction, concern of credit cycle, concern of higher interest rates).
- Financing by institutions for condo construction has become much easier to access, given the growing volume of activity.
- Off-plan purchases of condos has been well supported by foreign investors, reducing risk for developers.

The amount of equity required to support condo development and PBR is not materially different. Pre-sales may not reduce debt financing enormously – developers obtain insurance and insurance backs up debt. This is a mechanism that has been institutionalized by the lending community (quick and efficient execution). However, there has been greater private equity appetite for condo development given that:

- Private equity is short term but dynamic (easy to obtain). In contrast, there has been little appetite to support longer projects.
- Many mid-size investors are sophisticated and prepared to come in during the pre-construction period. IRR used to be higher (14-20% range), now in the 8-12% range.

Time horizons matter, and these have tended to differ between PBR and condo development. Investors can expect higher IRRs for condo development over PBR (starting at 1.2 times) over 3-6 years, as opposed to +25 years.

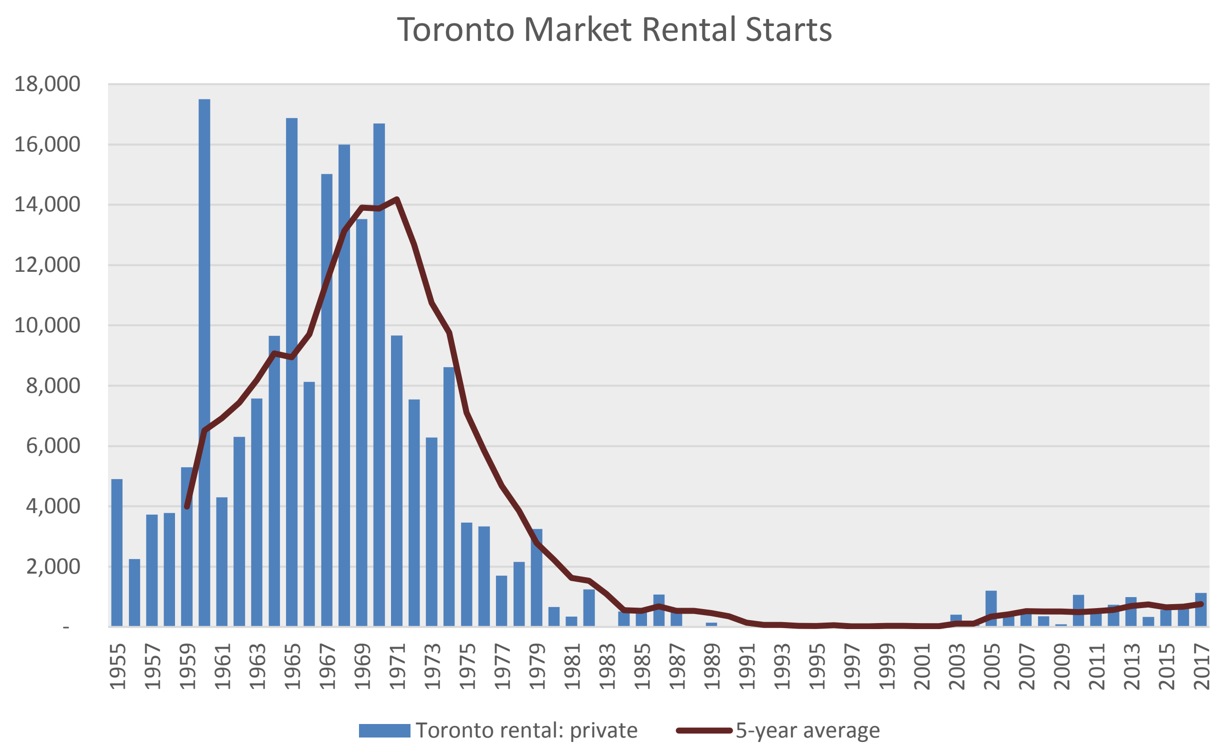
1.2 Overall Viability

To be able to move forward, a PBR project requires market rents to be able to remain above the levels of rents that make the project economically feasible.

FINDINGS

- Higher market rents have supported an upswing in interest in developing PBR, with projects aimed at the mid- to high-end market (GTA, Vancouver). In fact, in the GTA, PBR constructions hit a 25-year high in 2015, albeit from low levels (see Figure 2 for historical trends in Toronto).

Figure 2 Historical Rental Market Starts in Toronto



- Rent controls are a significant deterrent for PBR. The uncertainty of future rent control policy is equally a deterrent.
- PBR has a lower turnover of renters compared to condos, which means less ability to track market rents. As rents increase and stabilize, PBR begins to make more sense.
- Perceived volatility of policy, costs and land value changes appear to be significant factors when the risk-adjusted return to PBR is compared with that of condos. Comparing Montreal to Toronto provides a good illustration; Montreal has more constraints on rents and building form, yet many more PBRs are built in Montreal than Toronto. A factor that could be key in the calculus of risk-adjusted return is that construction costs and land values in Toronto have been twice those of Montreal.

1.3 Section Conclusions

In environments of greater uncertainty, condo development is considered more attractive to both developers and investors alike (higher risk-adjusted return over shorter time horizons). Condo development also provides more options and the ability to change with the market.

Given the longer time horizon of a PBR project, PBR business models tend to gravitate to stable environments (e.g. rent expectations, real estate values, local planning) that provide viable, risk-adjusted rates of return.

Further, the conditions for profitability of PBR development involve rents that have plateaued above economically feasible rents while still remaining within the range of what households will bear.

2.0 FINANCING MULTI-FAMILY RESIDENTIAL PROJECTS

2.1 INVESTOR PREFERENCES

The availability of financing options requires demand from investors for that type of investment.

FINDINGS

The lending community has grown accustomed to the types of returns generated by condo development. That is, investors expect a higher valuation at disposition, a certain level of returns and a low-risk bond structure. However, the valuation of a PBR property is related to the possibility of a future conversion to condos and the value of the land it is on (also driven by the condo market in many instances).

Developers feel that private equity is generally easy to obtain on the market through mid-sized investors who have an appetite for shorter-term returns, which lends itself better to the condo model. In contrast, demand for PBR investment comes mainly from institutional investors, e.g. pension funds, investment trusts. These use rental investments to diversify their holdings.

Until recently, there were fewer investors interested in steady returns over the long run than in the shorter-term, higher returns generated by condo development. The recent increase in demand could be in part be due to wealth created through condo development.

2.2 DIFFERENCES IN THE COST OF FINANCING CONDO AND RENTAL PROJECTS

The cost of financing depends on investors' perception of risk. Higher costs, in turn, impact the viability of a development project.

FINDINGS

We find that condo presales reduce perceived credit risk, since financing is typically offered after presale requirements have been fulfilled.

There are different costs associated with the financing of PBR and condo developments. Additional costs for PBR include mortgage insurance, loan insurance, and mortgage financing. Nonetheless, some developers feel that this is not a major impediment to the development of PBR (these costs have minimal impact on overall viability).

2.3 SECTION CONCLUSIONS

Although financing PBR can be slightly more costly than financing condo development, it does not appears to be a prohibitive factor. Furthermore, the appetite for investment in PBR is sensitive to the type of investor, i.e. shorter term investors versus "patient money". There is a sense that "patient money" is entering the market as asset returns globally have become more volatile.

3.0 COSTS

3.1 COST OF LAND AND CONSTRUCTION COSTS

The cost of land, along with the cost of construction, is one of the two main costs in the development of multi-family residential projects. Land cost therefore is a large determinant as to whether or not a project is viable. Rising land prices that exceed rent per sqft can reduce the profit margin for PBR development. Since land is a fixed cost, it can only be reduced per sqft by adding density to a building.

The cost of land is also a factor in determining what type of structure is most cost-effective to build. High-rise structures have higher construction costs per sqft than low-rise buildings which require fewer amenities (structural reinforcement, elevators, cost of operating specialized building equipment, e.g. cranes), as shown in Figure 1.

Figure 1 Construction Rates per sqft by Major Metropolitan Area

Developers in the PBR and condo spaces are bidding on the same land in Toronto and Vancouver. In cities such as Toronto and Vancouver where land is expensive, market rents have to be high enough to recoup the cost of land and construction. Alternatively, condo prices have to be high enough to cover these same expenses. In these markets, the condo model has been more profitable in recent decades, and market rents have been too low to be viable until recently. Therefore, PBR developers have usually been outbid by condo developers on land. Furthermore, expectations of prices on the condo market could be contributing to the increase in price of land.

In smaller cities where land is less expensive, the cost of building single-detached houses is less per sqft than building economical low-rise apartments. PBR appears to be most economically feasible for low- to mid-rise buildings, in part due to lower construction costs per sqft margin.

Although the components of building costs can differ, there appears to be little difference between the cost of developing a multi-family residential project for intended use as a condo or a PBR property, assuming the same type of structure. Sometimes, the cost of PBR can be higher (circa 10%) as a trade-off between current costs and life-cycle management of costs, such as maintenance.

3.2 Section Conclusions

In major CMAs such as Toronto and Vancouver where land prices are high, developments must increasingly be high-rise to recoup the cost of land. In these markets, rapidly rising housing prices have made condo developments profitable, enabling condo developers to outbid PBR developers for the same land. Until recently, market rents have not been high enough to recoup the cost of land and construction, rendering most PBR projects unviable. Montreal is an exception to the rule, as housing prices have not kept pace with other major cities in Canada. It is also subject to a history of height restrictions aiming at preserving its skyline.

In smaller cities and CMAs where land prices are not prohibitive and supply is relatively unconstrained, the low-price of land (in combination for lower per square foot construction costs for low-density construction) may reduce the demand for higher-density housing. Regulations on land use such as those seen in Quebec can contribute to limit low-density sprawl and increase demand for medium-density PBR development.

4.0 GOVERNMENT TAXES, CHARGES, POLICIES AND INCENTIVES

4.1 Impacts of Historical Tax Reforms

Investors consider after-tax profitability of an investment, which means that any relative advantage in the treatment of investment income from condo relative to PBR will change the incentives in the market.

FINDINGS

A drop in PBR development in most of the country (excluding Quebec) and the emergence of condo development coincides with major tax reforms that occurred in the 1970s. These tax reforms affected:

- Capital cost allowances (CCA), changing how depreciation on a building is treated.
  - When capital gains tax is applied on the recouped depreciation at disposition and the property value did not depreciate at the rate of CCA, this creates a disincentive to dispose of rental assets and reinvest that capital in further PBR development.
  - Capital gains rollover provisions, which deferred the payment of capital gains tax if the capital was reinvested into another rental asset within a specified time frame, removed this disincentive. These were eliminated in the course of reforms.
- Tax incentives that reduced the net operating income of rental properties. The incentives that were rolled back as part of the reforms included:
  - Write-offs for new housing investment, e.g. soft-cost deductibility and rapid deprecation/write-offs for the “brick and mortar” components of rental assets.
  - Flow-through provisions, which permitted losses from the operation of a rental property to be deducted against income.
- The application of GST/HST.
  - After the reforms GST/HST was to be applied to the full cost of new PBR development and ongoing operations.

4.2 Residential Properties as Investments

FINDINGS

PBR and condos differed in their treatment as investments.

- Rental properties were reclassified as “passive income” after 1986, resulting in a higher tax rate.
- Owner-occupied residences benefit from a capital gains exemption.

The federal government introduced programs for investors and homebuyers, such as:

- Savings programmes/tax exemptions for first-time homebuyers.

- Investment products, e.g. RRSPs.

Recently, some multi-residential properties have started to operate as rental properties but are registering as condos although all units belong to the developer. This has the advantages of reducing ongoing operating expenses and improves profitability and giving the owner flexibility to sell units individually or in bulk in the future.

4.3 Section Conclusions

The tax disparity between multi-unit PBR and condo development has favoured condo development, contributing to the large increase in condo developments and coincident with the decrease in PBR developments over the past 5 decades. Additionally, other types of investments have increased in attractiveness relative to PBR development for smaller investors, decreasing the pool of investors interested in financing PBR development.

5.0 CURRENT TRENDS AND OUTLOOK

5.1 The Institutionalization of Condo Development

- High returns from condo development and the increasing dominance of this model makes lending/borrowing easier.
- Condos have become the benchmark against which the potential returns for PBR projects are measured.
- Municipal processes have also been set up to facilitate condo development, as this type of development has become more frequent.

These factors are potentially reducing the relative transaction costs associated with developing condos compared to developing PBR.

5.2 Innovation in Rental Development

- There appears to be increased interest for mixed-use and mixed-tenure projects.
- Changes are observed in the retail sector, for instance, investors in shopping centres are looking to increase volume by adding infill rental projects.
- Developers and institutional investors with underutilized land are considering PBR housing as an approach to maximizing asset value.
- The first new PBR building to be completed in Mississauga in over 20 years is the result of a financial partnership between a rental operator and a pension fund.

5.3 Structural Changes in Demand

- There is an expected increase in demand from renters currently housed in older PBR.
- Rising interest among large-scale management firms in standalone PBR buildings that offer low and stable rates of return are seen as a way to diversify holdings.
- Significant growth in real estate investment trusts, pension funds and other institutional investors are contributing to changing preferences on the investment market. With large balance sheets, their appetite for products that can offer secure returns over the long term is growing.

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B. INTERVIEW STRUCTURE

Financial Considerations			
A. Metrics for assessing if project moves forward	Importance (circle one)	minimum value	Notes
10-year Internal Rate of Return	None / Low / High		
Return on Investment (ROI)	None / Low / High		
Capitalization Rate	None / Low / High		
Net Operating Income (NOI)	None / Low / High		
10-year Cash-on-Cash return	None / Low / High		
Return on Equity (ROE)	None / Low / High		
B. Raising upfront capital	Answer	Reason/Details	Notes
Rental development compared to condo development:			
Risk Level	Lower / Equal / Higher		
Costs	Lower / Equal / Higher		
Ability to obtain financing	Lower / Equal / Higher		
Advantages for developers of developing condos over rentals:			
Much of financing is withheld until majority of units are pre-sold makes it less risky	True / False		
Pre-sales reduce amount of debt financing and related interest charges, making it less costly	True / False		
Project ties up less of a developer's equity and for shorter periods	True / False		
Long-term investors are a main source of funding for rental projects (e.g.,pension funds, real estate investment funds)	True / False		
If true, challenges of reliance on long-term investors:			
Other investment opportunities on global market provide higher returns	True / False		
Investment risk in Toronto is high for long-term investors	True / False		
Purchasing existing rental properties in Toronto costs about half as much as developing new ones	True / False		
C. Additional costs for obtaining financing for rental projects compared to condo	Answer	Reason/Details	Notes
Impact of additional cost on feasibility:			
CMHC loan insurance for construction financing	None / Low / High		
Mortgage financing to pay off construction loan	None / Low / High		
Mortgage insurance from CMHC	None / Low / High		
Costs associated with delayed mortgage financing until rents have stabilized	None / Low / High		

Land Considerations			
A. Access to land	Answer	Reason/Details	Notes
Even playing field between condo & rental developers	True / False		
Rental development that occurs on existing land holdings	All / Most / Some / None		
Condo development that occurs on existing land holdings	All / Most / Some / None		
Type of development considered will depend on land cost	True / False		
Government incentives/land grands, e.g. Provincial Affordable Housing Lands Program have made possible previously infeasible rental developments	True / False		
High land costs in Toronto make most rental developments outside of basic (walk-up, basic finish, inner suburbs) infeasible	True / False		
B. Impact of site location	Answer	Reason/Details	Notes
On type of development (e.g., types of units, market segment, finish)	None / Low / High		
Ability to charge higher rents/higher prices	None / Low / High		
Lower price suburban (greenfield) are less expensive but poorer access to service & amenities	True / False		
C. Land transfer tax	Answer	Notes	
Impact on feasibiltiy of rental development project	None / Low / High		
Affects rental developers differently than condo developers	True / False		
D. Development charges	Answer	Notes	
Impact of feasibility of rental development project	None / Low / High		
Development charges affect rental developers similarly to condo developers	True / False		
The Development Charges Rebate Program has made possible previously infeasible rental developments	True / False		

Approvals Process		
A. Timeline uncertainty	Answer	Notes
Uncertainty in approvals process is		
because they depend on multiple players	True / False	
because they depend on characteristics of site	True / False	
often due to changes in land use planning	True / False	
B. Rental developers' risk	Answer	Notes
Rental developers bear more risks due to uncertain timelines than condo developers. If true:	True / False	
They must absorb any unexpected increases in development charges and fees	True / False	
Servicing (e.g., sewage) may not be available as needed and could delay move-in dates	True / False	

Development			
A. Construction costs	Answer	Reason/Details	Notes
Impact of type of building materials on project feasibility gap (on sq. ft. buildable basis) between rental and condo	None / Low / High		
Impact of HST on project feasibility gap between rental and condo developments	None / Low / High		
Impact of cost overruns on general rental development feasibiltiy	None / Low / High		
B. Market/Economic risks	Answer	Reason/Details	Notes
Risks increase with the size and complexity of a rental project	True / False		
Risk of changes in the rental market during development threatening a project's fesibility	None / Low / High		
Risk of interest rate increases before mortgage financing is locked in threatening a rental project's feasibility	None / Low / High		

Operation			
A. Impact on Net Operating Income	Answer	Direction of effect	Notes
Market rent	None / Low / High		
Size of development	None / Low / High		
Finish of development	None / Low / High		
Non-rent income (e.g. laundry facilities, parking)	None / Low / High		
Rent controls	None / Low / High		
Operating costs	None / Low / High		
Maintenance	None / Low / High		
Capital improvements	None / Low / High		
B. Level of risk to profitability	Answer	Notes	
Tenant credit	None / Low / High		
High vacancy	None / Low / High		
Uncertainty in timeline for reaching operating stability	None / Low / High		
Excessive damage	None / Low / High		
Interest rate increases	None / Low / High		

Rental Property Disposition			
A. Market Value	Answer	Other	Notes
Current property value assessed as NOI/Cap Rate	True / False		
Cap rate determined based on appraisals of recent sales of similar projects	True / False		
Market value of owner's equity increases as market value increases & mortgage is paid off	True / False		
Owner can improve ROE by refinancing or by selling	True / False		

B. Costs incurred by an owner when selling a rental property	Answer	Notes
Outstanding balance on mortgage	None / Low / High	
Selling costs	None / Low / High	
Capital gains tax	None / Low / High	
Taxes on Capital Cost Allowance	None / Low / High	
HST	None / Low / High	

Government Taxes, Charges, Policies and Incentives		
A. HST	Answer	Notes
Impact on feasibility of a rental project	None / Low / High	
Impact on feasibility gap between rental and condo developments	None / Low / High	
B. Capital Gains Tax & CAA	Answer	Notes
Rental buildings in Toronto depreciate at a ____ rate than the annual CAA rate of 4%	Lower / Equal / Higher	
Impact of capital gains tax on recaptured CAA on decision to sell a rental property	None / Low / High	
Capital gains exemption for owner-occupied principal residences allow condo developers to outbit rental in marketplace for multi-family development sites	True / False	
C. Rent Control	Answer	Notes
Ensuring sufficient growth in NOI is difficult in competitive, rent-controlled environments	True / False	
D. Classification of rental operations as passive income	Answer	Notes
Higher tax rate decreases number of potential investors in rental properties	True / False	
E. New multi-residential property tax class	Answer	Notes
Impact on feasibility of a rental development project	None / Low / High	

General Viability/Feasibility of a Project			
A. Types of rental projects that have been viable in the past 20 years	Details	Notes	
Developer characteristics			
Existing land holdings or purchased land			
Location			
High-, medium-, or low-rise			
High-, medium-, or low-end			
B. What are the biggest costs and risks at every stage of a rental development project that impact its viability?	Costs	Risks	Notes
Financing			
Land acquisition			
Approvals			
Development			
Operation			
Disposition			
Overall			
C. Are there any additional significant considerations that rental developmers must account for when determining viability?			