# RESEARCH REPORT

Housing Affordability and Finance Series

# Understanding private rental housing investment in Canada

Canada

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# *Understanding Private Rental Housing Investment in Canada*

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Clayton Research Associates Limited and Fish Marks Jenkins Real Estate Consulting were commissioned by Canada Mortgage and Housing Corporation (CMHC) to undertake this study of private rental housing investment in Canada.

The key study objectives were:

- To examine the nature and extent of private rental housing investment in Canada;
- To develop a profile of who is investing in private rental housing; and
- To establish a thorough understanding of what investors and lenders consider in their decision-making process.

The ultimate goal of the research was to provide a solid basis from which public and private sector decision-makers can act in an informed manner.

Investment in private rental housing for this study includes:

- **Developing** new "purpose-built" rental properties for own portfolio or for sale to other investors;
- **Purchasing** rental properties from a previous investor (or developer);
- **Holding/owning** existing rental properties on an on-going, longer-term basis;
- **Converting** purpose-built owner-occupied or non-residential space to rental tenure - either temporarily or permanently; and
- **Upgrading** existing rental properties (i.e. renovation/repair work).

Highlights and key findings of the study are summarized below.

## The Nature and Extent of Private Rental Housing Investment

- There are about 4 million rental housing units in Canada, the majority of which are owned by the private sector.
- The stock of rental units in Canada grew rapidly during the 1960s and 1970s before entering a period of more moderate growth in the 1980s and falling further in the 1990s.
- Purpose-built private rental units have played a declining role in the growth in the total rental stock since the 1970s.
- The gap has been made up by a variety of other types of rental housing - including social/assisted units and converted units (single-family homes and condominiums being rented out by their owners, and secondary suites/accessory apartments).
- Investment in new purpose-built private rental units has been relatively low in recent years. Only about 6,000 new units per year have been developed since 1992 in Canada's major markets - this is less than one-quarter of the levels built in the 1986-1991 period.
- But interest in the existing rental stock has picked up in recent years. While comprehensive information on total sales activity is not available, sales transactions have been more buoyant in recent years compared to the first part of the 1990s, in particular in Toronto, Montreal and Edmonton.
- There is also investment occurring in the upkeep and upgrading of existing private rental units. Landlords in Canada in total spent almost $4 billion on repairs and renovations to private rental units in 1995 - or approximately $1,200 per unit.

## The Environment for Private Rental Housing Investment in the 1990s

- Rental vacancy rates started to rise dramatically in Canada's major markets in the latter 1980s - and have remained high in historical terms through the 1990s (although they are now on the decline). As a result, real rent increases have not been obtainable in most centres in recent years.
- Vacancy rates and rents reflect the interaction between demand and supply. While there have been relatively few new rental units constructed in recent years, the relatively high levels of assisted housing units constructed in the early 1990s in Ontario did contribute to higher private sector vacancy rates (as this source offered competition to the private sector), as did overbuilding of private rental units in the latter 1980s in some centres (e.g Montreal and Winnipeg).
- Demand side factors have also played a role. The sharp increase in the overall vacancy rate in the early 1990s reflected the weak economic conditions in most major markets at that time, as well as less favourable demographics (with fewer households in the prime first-time renter age groups). In addition, favourable affordability of homeownership, due to historically low mortgage interest rates, and house price declines in the early 1990s, have increased the relative attractiveness of owning vs. renting - and lured many first-time buyers away from the rental market.
- While important in the past, at present there are no federal government programs in place to encourage investment in new private rental units.
- There have been several changes related to financing private rental investment since the early 1980s that have either enhanced or detracted from the attractiveness of private rental housing. On the positive side, the key change is the low interest rate environment that currently prevails; favourable rates in general have been enhanced further by competition among lenders. On the negative side, however, several key changes to lending/insuring policies since the early 1980s (when lenders and insurers suffered heavy losses on real estate) have detracted from the attractiveness of rental investment, including the reduction in maximum loan values for insured mortgages from 90% to 85%, the unwillingness of lenders to lend on negative cash flow, and increases in CMHC mortgage insurance premiums and the stricter underwriting criteria introduced in 1996.
- Six out of 10 provinces in Canada still have some system of rent controls/review, although in some cases (such as in Ontario and B.C.) the systems are currently less stringent than in past years. The existence of rent controls/review, and policy shifts among successive provincial governments, have complicated the investment decision, as investors do not necessarily know when, and to what extent, the rules may change after the decision to invest has occurred.
- The income tax advantages that investors in rental housing previously enjoyed were a key factor behind buoyant investment in the 1960s and 1970s. However, several changes have been made in the treatment of rental housing for income tax purposes since the early 1970s - which have seriously reduced the attractiveness of investment in rental housing in Canada.

## Profile of Investors in Private Rental Housing

- Small investors play an important role in private rental investment in Canada - this group owns almost half of the private rental stock. While the role of institutional investors - such as public real estate companies, REITs and pension funds - has been growing rapidly in recent years, combined these groups still own less than 5 percent of rental units. The remainder of the private rental stock is in the hands of medium and large investors.

- In general, investors in private rental housing are in it for the longer-term - that is, at least 10 years. The key exception is the pension funds, which tend to take a medium-term (5 to 10 year) view for their investments.
- The factor that investors most often cited as being a key determining factor in the decision-making process was location, followed by the expected rate of return on the project, and the quality/condition of the building.
- The main advantages of investment in rental housing compared to other types of real estate are perceived to be the stable cash flow, and the lower risk. Both of these factors are in large part a function of lower, less volatile vacancy rates than in other sectors. The lower level of risk is also a product of the fact that there are many, diverse tenants, and the on-going need for housing.
- The main disadvantages of investment in rental housing compared to other types of real estate are perceived to be the condition of the stock (and the potential need for extensive investment in capital upgrades), high property taxes and the extent of government intervention.
- The most common methods of measuring returns on rental investment are cash flow, cash-on-cash returns and cap rates. Few investors consider "total" returns (i.e. including capital appreciation) on a regular basis.
- Returns being achieved have varied by market. Cap rates for recently purchased existing buildings in the 6 major markets under special review in this study ranged from between 7.5% (Vancouver) to 10.5% (Halifax) in 1997. Cash-on-cash returns varied even more, from less than 10% in Calgary and Vancouver to 25% in Halifax.

## Focus on Investment in New Private Rental Housing

- As with investors in existing housing, investors in new rental housing perceive the main advantages relative to other types of real estate as being stable cash flow, less risk and lower vacancies.
- The main disadvantages are perceived as the extent of government intervention and high property taxes.
- The key factor in the decision-making process for investors in new rental buildings is the economic viability of a project, followed by its location.
- There appears to be increased interest in developing new rental units. However, the poor economics of new rental unit development remains a stumbling block.
- For the 6 major markets examined in this study (Halifax, Montreal, Toronto, Winnipeg, Calgary and Vancouver), the potential cash-on-cash returns for new rental unit development are generally well below the minimum 15% that developers typically are seeking.
- As well, returns on new development are not attractive in relation to returns on existing investment, particularly in Toronto and Montreal.

## Future Prospects and Implications for Key Players

- CMHC projections indicate that the underlying demand for additional rental units will be growing over the next 20 years. Higher levels of renovation work are also expected to be needed, in response to an aging rental stock, and desirable renovations sought by some investors seeking to reposition their units to be more attractive to higher income renters.

- Given lower vacancy rates, and the potential for higher rents, opportunities for new rental unit development, as well as higher levels of repair and renovation work, are expected to emerge sooner in Calgary and Toronto than Halifax, Montreal, Winnipeg or Vancouver.
- Investors, developers, lenders, mortgage insurers and governments will each face their own challenges and opportunities in the rental sector, as discussed below.

### *Investors in Existing Housing*

- **The Opportunities**: demand for rental housing over the next 20 years is expected to grow by roughly 50,000 units a year. This buoyant demand means that the oversupply currently exhibited in most markets will be gradually worked down - which bodes well for future real rent increases, and, other things being equal, higher returns. Current owners of existing housing may also benefit from the fact that the supply of "distressed" properties has been worked down in most markets. Competition among those investor groups who have indicated strong expansion plans (such as the REITs and real estate companies) could act to bid up values of existing properties.
- **The Challenges**: A key challenge for investors in the existing housing stock is the current state of repair. It is expected that increasingly higher levels of investment will be needed to keep the stock from deteriorating, particularly as it continues to age in relative terms. This will increase both operating expenses and, if funds are borrowed, the level of debt payments - which will temper the returns that might otherwise be achieved as rents rise. Another key challenge is the extent of government intervention in the rental sector - either directly, through rent control/review schemes and landlord/tenant legislation, or indirectly through government imposed costs. In particular, changing rules and swings - often back and forth - in policies by successive governments have created a climate of uncertainty for investors in existing rental housing.

### *Developers/Builders of New Purpose-Built Rental Housing*

- **The Opportunities**: The relatively more buoyant rental demand levels expected over the next 20 years compared to the 1990s thus far suggests that there will be a substantial need for additional rental units to be built, particularly once excess vacancies in the existing stock are worked down. And in Ontario, recent actions by the province, such as exemption of new units from rent increase ceilings indefinitely, and the potential for property taxes in the future to be more in line with ownership housing, have further enhanced interest in new construction. As well, there appears to be a growing interest in new buildings among investors who have previously focused on the existing market (e.g. pensions funds, REITs). There may, therefore, also be emerging opportunities for developers to build properties for sale to other investors, rather than for retention in their own portfolios.
- **The Challenges**: The key, and substantial, challenge for this group will be overcoming the current poor economics of new purpose-built rental unit development. In addition, while interest rates are favourable for financing new investment at present, the uncertainty of future interest rate trends, and the potential for reduced cash flow if rates were to rise substantially, still makes investment in this sector precarious.

### *Renovators*

- **The Opportunities**: As already discussed, the need for maintaining and revitalizing the existing rental stock will be growing over the next 20 years. At the same time, the stock will be growing - and with it, growth in the number of units that will require some work. In addition, the opportunity for higher rents presented by the new Tenant Protection Act in Ontario is expected to lead some landlords to undertake substantive upgrading of units in order to reposition them in the market. Depending on the actual strength of demand for additional rental units, and the proportion that can be accommodated by new purpose-built rental housing, renovators may also face opportunities in converting single-family homes to multiple rental suites, or in adding accessory suites/apartments in an investor's principle residence.
- **The Challenges**: While the potential for higher levels of rental repair and renovation work is there, whether it will be realized is not certain. Rather, it depends in large part on the extent to which investors feel that they can achieve a return on their investment in upgrading their units. It will also depend on the extent to which additional public funding may be made available to deal with the problems of a deteriorating stock.

### *Lenders and Mortgage Insurers*

- **The Opportunities**: To the extent that the economics of new rental development improve in specific markets, and somewhat higher levels of investment start to emerge, there will be more opportunities to finance and insure new rental projects. The potential growth in investment in upgrading the rental stock will provide additional business for lenders and mortgage insurers.
- **The Challenges**: The amount of lending and insuring that takes place will follow the cyclical pattern normally evident in real estate. In the existing market, lenders and insurers, therefore, can likely expect some decline from the recent relatively buoyant levels of activity in general, although demand from certain types of investors who have announced strong acquisition plans (such as the public real estate companies and REITs) is likely to continue to increase. Discussions with investors indicate that for CMHC there is the added challenge of competing with conventional funding for existing properties, at least among that group of investors who are unhappy with what they perceive to be burdensome approval criteria and an onerous process. As well, CMHC may miss out on opportunities to insure new rental development in those cases where the proponent finds the CMHC criteria/process unfavourable and decides not to proceed at all with the project.

### *Government*

- **The Opportunities**: To the extent that higher levels of new rental development and upgrading of the existing rental stock occur, governments at all levels will benefit financially from revenues derived from associated direct and indirect taxes and from the increase in employment that will occur.
- **The Challenges**: From a policy perspective, governments have a stake in ensuring an adequate, and well-maintained, supply of rental housing. One of the main challenges for government will be to ensure that any government-originated costs to rental investment, particularly in developing new rental units, are fair and do not represent an undue burden. If investment in upgrading the existing stock is not initiated by private investors because it is not justified by expected returns to this investment, governments face the challenge of considering alternatives (such as enhanced

programs/subsidies) to encourage the necessary repairs and renovations.

### *Facing the Challenges*

- Investors and others had several suggestions for dealing with the key challenges, as discussed below.

### *Challenge #1: Improving the Economics of New Rental Unit Development*

- In general, potential investors in new rental housing indicated that they are not looking for "handouts" in the form of subsidy programs or a return to favourable tax treatment (although there were a few who held the opposite opinion). Most often, suggestions for meeting the challenge of the poor economics of new rental investment were aimed at removing what are perceived as current "roadblocks" or inequitable treatment. The most common specific suggestions included:
  - Lowering project development costs by reducing the extent of government-imposed costs, such as development charges, lengthy approvals processes, overly stringent building code requirements, etc.;
  - Putting new rental housing on par with new ownership housing in terms of rebates for the GST/QST/HST, and property tax assessment; and
  - Encouraging the federal government to pursue policies which promote a healthy economy (which are favourable for demand) and a low interest rate environment (which is favourable for costs of financing and cash flow).

### *Challenge #2: The Extent of Government Intervention and Uncertainty Re: Future Policy Shifts*

- Suggestions for dealing with this challenge were largely in the vein of simply reducing the amount of "hands-on" direct government intervention in the rental sector, in particular in terms of rent control/review schemes and landlord tenant legislation - and by doing so, also eliminating the uncertainties associated with constant policy swings between successive governments.
- The prevailing sentiment among investors in this respect can be summed up by the phrase "let the market operate".

### *Challenge #3: Maintaining/Upgrading the Existing Stock*

- The main suggestion for meeting this challenge was to remove any artificial barriers to rent increases where they still exist and therefore improve the potential returns to investors for maintaining the condition of the stock.

### *Challenge #4: Overcoming the Negative Perception Among Some Investors About the CMHC Mortgage Insurance Product/Process*

- There were several key suggestions in this area:
  - Speed up the process so that the turnaround time from application to approval is reduced;
  - Introduce premiums and criteria which recognize the risk differentials among different applicants based on their past track record and different local market circumstances; and
  - Use actual mortgage rates to determine debt-coverage ratios and market determined capitalization rates to determine lending values, rather than a 9% rate (since the interviews were

conducted, CMHC has announced both these changes for existing properties).

### *Seizing the Opportunities*

- In addition to the above direct suggestions, which tended to focus on factors outside the investors' control, it was observed that some investors are attempting to enhance the attractiveness of rental investment through factors which they can control. These include:
  - **Repositioning units to achieve higher rents**: as discussed earlier, some investors, particularly in the Toronto area, are assessing the potential paybacks/higher rents that would be achievable by upgrading their units to attract higher income renters.
  - **Reducing controllable costs:** while some operating costs such as property taxes are not within the control of the investor, others such as maintenance and administration are. Some investors are investigating ways that they could reduce their controllable costs. These range from adopting new technologies to achieving economies of scale by growing their own portfolio, or merging with smaller investors/companies.
  - **Public/private partnerships**: at least one developer was investigating a partnership with a municipality to develop rental housing on municipally owned land.
  - **Spreading the risk:** the emergence of REITs and public real estate companies from previous privately owned companies has not only allowed for additional capital inflow to aid expansion plans, but also enhanced the attractiveness by spreading the risk among a larger number of investors.

## Directions for Future Research

- The understanding of private rental housing investment in Canada could be enhanced by additional research.
- One initiative might be to explore the broader feasibility of the suggestions offered by investors and lenders for enhancing the attractiveness of rental investment.
- A second potential initiative would be to explore the feasibility of undertaking a large scale survey of rental investors. Such a survey could help to fill existing data gaps, in particular with respect to the profile of investors and their characteristics, as well as the levels of returns being achieved.
- A third potential initiative is to explore the possibility of using already existing vehicles (such as CMHC's mortgage insurance application system) for collection of information related to rental investors.
- A fourth potential initiative would be to conduct periodic follow-ups to this study to deal with any future changes in the environment for rental housing investment. Factors which impact rental investment are changing rapidly. Even during the course of the research for this study, many changes occurred (such as in government policy and rental market conditions) which have impacted on the attractiveness of rental investment.

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# CHAPTER 1 - INTRODUCTION

Clayton Research Associates Limited and Fish Marks Jenkins Real Estate Consulting were commissioned by Canada Mortgage and Housing Corporation (CMHC) to undertake this study of private rental housing investment in Canada.

## Study Objectives and Goal

The key study objectives were:

- To examine the nature and extent of private rental housing investment in Canada;
- To develop a profile of who is investing in private rental housing; and
- To establish a thorough understanding of what investors and lenders consider in their decision-making process.

The ultimate goal of the research was to provide a solid basis from which public and private sector decision-makers can act in an informed manner.

## What is Private Rental Housing Investment?

Rental housing can be divided into two broad sectors:

- **Private rental housing** refer to units owned by private sector investors; the owner or occupants may have received a government subsidy/incentive at some point, but the units themselves remain in the hands of the private sector.
- **Social/assisted rental housing** includes any publicly owned rental buildings, including non-profit and co-op buildings.

It is **private rental housing** which forms the focus of the current study.

Investment in private rental housing can take a variety of forms, including:

- **Developing** new "purpose-built"[1] rental properties for own portfolio or for sale to other investors;
- **Purchasing** rental properties from a previous investor (or developer);
- **Holding/owning** existing rental properties on an on-going, longer-term basis;
- **Converting** purpose-built owner-occupied or non-residential space to rental tenure[2] - either temporarily or permanently; and
- **Upgrading** existing rental properties (i.e. renovation/repair work).

This report covers each of these various types of private rental investment to some degree. However, the emphasis of the analysis, particularly with respect to the development of a profile of rental investors, is on what are termed

[1] "Purpose-built" rental units are defined as units in apartment and row/townhouse projects (and in a few cases, single-detached and semi-detached homes) where the structures were originally built with the explicit intention that they would be rented out. This definition is consistent with CMHC's segmentation of starts and completions data by "intended market", which classifies units as rental if the intention is to rent out the units immediately upon completion. Based on this definition, an apartment project which obtained condominium registration for future flexibility, but which is being fully rented out upon completion, would be considered a rental project.

[2] "Converted" rental units include units in structures which were originally intended for ownership tenure upon completion but are now being either permanently or temporarily rented out; these include:
- Secondary suites in single-family homes (i.e. basement/accessory apartments, flats, etc.);
- Condominium units being rented out (with the exception of syndicated buildings with condominium registration where the entire building is originally rented out, which are considered as "purpose-built" rental);
- Single-family homes being rented out; and
- Conversions of non-residential space to rental units.

"active" investors - those who invest in new units, or are purchasing existing units.

## The Key Players

There are several key players in private rental investment:

- **Investors** purchase/own private rental units;
- **Developers** undertake the actual development/construction of new private rental units;
- **Lenders** provide the financing/mortgages for new rental unit development or the acquisition of existing rental properties, and refinancing for renovation work;
- **Mortgage insurers** (essentially CMHC) provide lenders with protection against losses in case of default by the borrower;
- **Brokers** match up interested buyers and sellers of private rental properties, and often help arrange the financing; and
- **Government** has a broad role including taxation, rent control/review, landlord tenant legislation, regulation, etc.

The more specific role of each of these players is addressed further in various sections of the report.

## Geographic Scope

The study takes a Canada-wide view of private rental investment. Where available, statistical information is presented for the 26 Census Metropolitan Areas (CMAs); for simplicity, these are referred to in these report as Canada's "major markets". The focus on CMAs, rather than provinces/regions, is felt to be more appropriate for a study of rental investment, as local markets are what are important to investors.

In addition, the following 6 major markets have been selected for more in-depth analysis in some instances:

- Halifax
- Montreal
- Toronto
- Winnipeg
- Calgary
- Vancouver

These centres were chosen as they are among the largest rental markets, and also provide for a degree of geographic variation.

## Information Sources

A variety of information sources were used in the course of this study.

In an initial phase of the study, an extensive literature review was conducted, and a plethora of research on rental investment was uncovered. A summary of the findings, and their relevance to the current study, were presented in an interim report.

Where appropriate, relevant findings from the existing research have been referenced in this report. However, for the most part, it was determined that existing research was lacking in terms of the objectives of the current study.

Therefore, this study depends in large part on original, or as yet untapped, information sources. These include:

- **Structured interviews with key players** in rental investment, including developers, institutional investors (e.g. pension funds, REITs, public real estate companies), other medium and larger investors, brokers and lenders;
- **Data from CMHC's insurance underwriting data base**, which tracks a variety of information related to rental housing transactions which involved CMHC mortgage insurance;

- **Original information compiled by Fish Marks Jenkins** (and its affiliates in major markets across Canada)[3] on recent sales of larger rental buildings;
- **Custom research on small rental investors** commissioned by CMHC on the March 1998 FIRM Residential Mortgage Survey;
- **Selected questions added to the Spring/Summer 1998 CHBA Pulse Survey** of Canadian home builders on rental housing activity; and
- **New data from the Rental Repair and Renovation Expenditure Survey**, conducted by Statistics Canada on behalf of CMHC and analyzed by Clayton Research for CMHC.

## Structure for the Remainder of the Report

In addition to this **Introduction**, the report contains 6 other chapters:

- **Chapter 2 - The Nature and Extent of Private Rental Investment** looks at the nature of the private rental housing stock in terms of its size and composition and examines recent investment levels.
- **Chapter 3 - The Environment for Private Rental Housing Investment in the 1990s** first examines current rental market conditions in the major markets. This is followed by a brief discussion of some of the key "external" factors which impact on rental investment but which are not directly controllable by the investor - such factors as taxation, financing, government policies/regulations, etc.
- **Chapter 4 - Profile of Investors in Private Rental Housing** looks at who is investing in private rental housing, their behaviour with respect to rental investment and their motivations.
- **Chapter 5 - Focus on Investment in New Private Rental Housing** develops a profile of investors in new private rental housing and examines the economic viability of new purpose-built private rental housing.
- **Chapter 6 - Future Prospects and Implications for Key Players** examines the prospects for investment in private rental housing and the implications for key players, including investors, developers, lenders, mortgage insurers and government.
- **Chapter 7 - Directions for Future Research** explores potential future research initiatives which could help to enhance our understanding of private rental investment in Canada.

[3] The affiliates who participated in this study (primarily in the compilation of data on recent rental building transactions and/or the structured interviews) include: Hardy Appraisals (Halifax), Groupe LCBA (Montreal), Higgs, Cameron, Cyr & Wilson Ltd. (Ottawa), Navrady Kelly Maslen Inc. (Calgary), Keith Fraser & Company Ltd. (Edmonton) and Nilsen Realty Research Ltd. (Vancouver).

# CHAPTER 2 - THE NATURE AND EXTENT OF PRIVATE RENTAL HOUSING INVESTMENT

The chapter focuses on the nature and extent of private rental housing investment in Canada.

The chapter begins with a brief look at the nature of the rental housing stock in terms of its size and composition.

This is followed by an examination of the extent of rental investment activity of various forms, including:

- Development of new private rental units;
- Acquisitions of existing rental units; and
- Upgrading of the existing rental stock.

## The Nature of the Rental Stock in Canada

This section examines the nature of the rental housing stock, in terms of its size and composition.

### Over 3 Million Private Rental Housing Units in Canada

According to the 1996 Census of Canada (the latest comprehensive information available on the housing stock), there are just over 3.9 million occupied rental units in Canada. This represents about 36 percent of the total occupied housing stock (Figure 1).

Of the 3.9 million rental units, roughly 0.6 million units are estimated to be assisted housing (public housing, coops and non-profit units). Therefore, the stock of occupied private rental units is roughly 3.3 million units. It should be noted that the Census of Canada does not distinguish between private and assisted rental housing. The assisted housing estimates have been derived in consultation with CMHC.

### Only 1 in 5 Rental Units Are in High-Rise Apartment Buildings

The rental housing stock (private and assisted units combined) is made up of a variety of structural types (Figure 2).

Single-detached houses account for 1 in 6 rental units. This category includes only homes which are being rented out in their entirety to one household. Single-detached homes which have been subdivided into two or more rental suites are classified as "apartments/flats in detached duplexes" and are included here in the "all other" category.

Units in high-rise apartment buildings (buildings with five or more storeys) account for only about 1 in 5 rental units across Canada. This category includes both purpose-built rental units, as well as units in high-rise condominium apartment buildings which are being rented out by their owners, or the developer.

The remaining two-thirds of rental units are made up of a variety of housing types. Data from the 1996 Census of Canada (Table 1) show that the majority of "other" types of rental units are in low-rise apartment buildings (i.e. apartment buildings of 4 or less storeys, including plexes). As well, low-rise apartments exhibited the strongest growth over the 1991-1996 period.

Together, units in high-rise and low-rise apartment buildings account for about two-thirds of all occupied rental units.

**Figure 1**

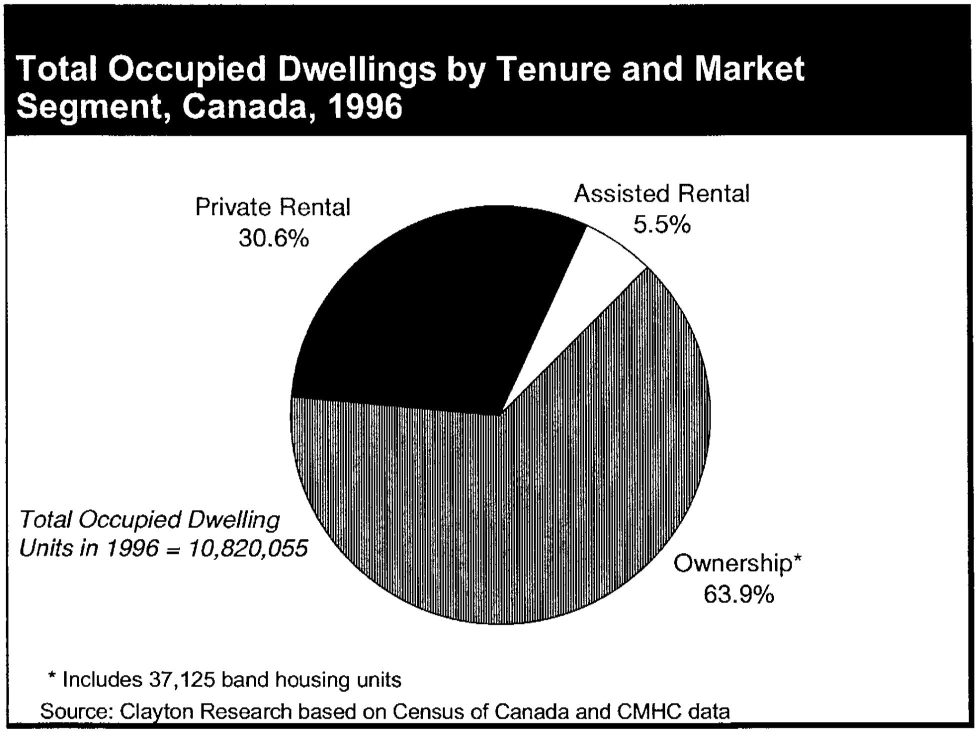



**Figure 2**

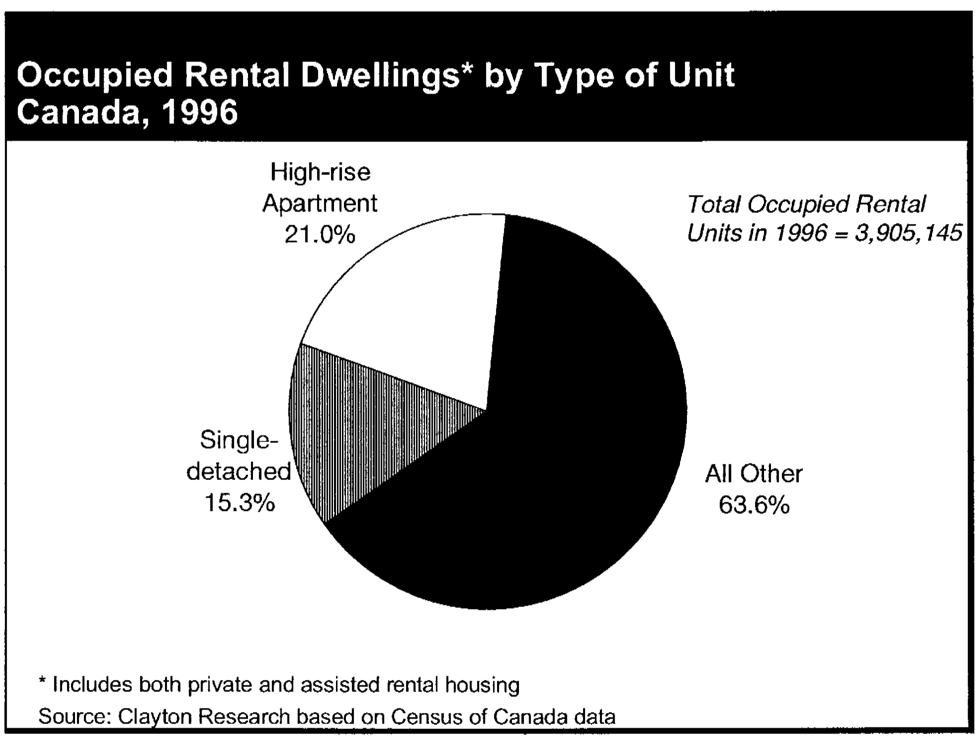


Table 1

**Occupied Rental Dwellings by Structural Type Canada, 1991 and 1996**

| | Number of Occupied Units (000s) | | | % of Total | | |
|---|---|---|---|---|---|---|
| | 1991 | 1996 | Avg. Ann. Change 1991-96 | 1991 | 1996 | Avg. Ann. Change 1991-96 |
| Single-detached | 583 | 598 | 3 | 15.7 | 15.3 | 8.1 |
| High-Rise Apartment | 785 | 822 | 7 | 21.1 | 21.0 | 19.9 |
| All Other: | 2,351 | 2,485 | 27 | 63.2 | 63.6 | 72.0 |
| *Semi-detached* | *169* | *165* | *-1* | *4.5* | *4.2* | *-2.2* |
| *Row/townhouse* | *273* | *278* | *1* | *7.3* | *7.1* | *2.7* |
| *Low-rise apartment* | *1,614* | *1,709* | *19* | *43.4* | *43.8* | *51.1* |
| *Apt./flat in detached duplex* | *243* | *287* | *9* | *6.5* | *7.3* | *23.7* |
| *Single-attached* | *27* | *22* | *-1* | *0.7* | *0.6* | *-2.7* |
| *Mobile/movable* | *25* | *25* | *0* | *0.7* | *0.6* | *0.0* |
| Total | 3,719 | 3,905 | 37 | 100.0 | 100.0 | 100.0 |

Source: Clayton Research based on Census of Canada data

### Rental Investment Focused in the Major Markets

Rental investment is focused in the major markets in Canada (Table 2). In 1996, over 70 percent of occupied rental units (private and assisted combined) were located in the 26 census metropolitan areas (CMAs); this is substantially higher than the 58 percent of Canada-wide ownership dwellings located in these centres.

Just under half of the rental stock is located in the six major markets which were selected for special focus in this study - Halifax, Montreal, Toronto, Winnipeg, Calgary and Vancouver. The three largest rental markets - Montreal, Toronto and Vancouver - alone account for over 40 percent of the total stock of rental housing in Canada.

The relative importance of rental versus ownership tenure varies by major market. For example, in some centres, such as St. Catharines and Oshawa, rental housing accounts for less than 30 percent of the total housing stock; in Montreal, on the other hand, it is more than half.

### Composition of the Rental Stock Varies by Major Market

The makeup of the rental stock by structural type also varies substantially by market area (Table 3).

For example, high-rise apartments play a much more important role in the major markets of Ontario (in particular, Toronto), as well as Winnipeg.

**Table 2**

## Occupied Dwellings by Major Market Canada, 1996

| Census Metropolitan Area (CMA) | Number of Occupied Units | | | Percent of Canada Total | | | Renter as % of Total |
|---|---|---|---|---|---|---|---|
| | Owner | Renter | Total* | Owner | Renter | Total* | |
| St. John's | 40,675 | 19,620 | 60,295 | 0.6 | 0.5 | 0.6 | 32.5 |
| Halifax | 76,370 | 51,105 | 127,490 | 1.1 | 1.3 | 1.2 | 40.1 |
| Saint John | 30,850 | 16,205 | 47,050 | 0.4 | 0.4 | 0.4 | 34.4 |
| Chicoutimi | 36,440 | 23,490 | 59,935 | 0.5 | 0.6 | 0.6 | 39.2 |
| Quebec City | 151,415 | 124,515 | 275,935 | 2.2 | 3.2 | 2.6 | 45.1 |
| Sherbrooke | 30,560 | 30,295 | 60,855 | 0.4 | 0.8 | 0.6 | 49.8 |
| Trois Rivieres | 31,990 | 25,670 | 57,665 | 0.5 | 0.7 | 0.5 | 44.5 |
| Montreal | 649,895 | 691,375 | 1,341,270 | 9.4 | 17.7 | 12.4 | 51.5 |
| Hull | 58,195 | 36,395 | 94,590 | 0.8 | 0.9 | 0.9 | 38.5 |
| Ottawa | 169,030 | 121,525 | 290,550 | 2.5 | 3.1 | 2.7 | 41.8 |
| Oshawa | 66,910 | 26,805 | 93,710 | 1.0 | 0.7 | 0.9 | 28.6 |
| Toronto | 869,570 | 618,795 | 1,488,375 | 12.6 | 15.8 | 13.8 | 41.6 |
| Hamilton | 153,640 | 81,965 | 235,605 | 2.2 | 2.1 | 2.2 | 34.8 |
| St. Catharines | 102,205 | 42,300 | 144,505 | 1.5 | 1.1 | 1.3 | 29.3 |
| Kitchener | 87,600 | 52,860 | 140,460 | 1.3 | 1.4 | 1.3 | 37.6 |
| London | 93,685 | 62,330 | 156,015 | 1.4 | 1.6 | 1.4 | 40.0 |
| Windsor | 72,605 | 33,185 | 105,790 | 1.1 | 0.8 | 1.0 | 31.4 |
| Sudbury | 38,755 | 23,185 | 61,940 | 0.6 | 0.6 | 0.6 | 37.4 |
| Thunder Bay | 34,080 | 14,775 | 48,885 | 0.5 | 0.4 | 0.5 | 30.2 |
| Winnipeg | 167,320 | 94,515 | 261,920 | 2.4 | 2.4 | 2.4 | 36.1 |
| Regina | 49,340 | 25,355 | 74,695 | 0.7 | 0.6 | 0.7 | 33.9 |
| Saskatoon | 51,935 | 32,560 | 84,535 | 0.8 | 0.8 | 0.8 | 38.5 |
| Calgary | 199,965 | 105,340 | 305,305 | 2.9 | 2.7 | 2.8 | 34.5 |
| Edmonton | 206,140 | 113,465 | 320,065 | 3.0 | 2.9 | 3.0 | 35.5 |
| Vancouver | 411,400 | 281,315 | 692,960 | 6.0 | 7.2 | 6.4 | 40.6 |
| Victoria | 80,390 | 48,925 | 129,350 | 1.2 | 1.3 | 1.2 | 37.8 |
| Total All CMAs | 3,960,960 | 2,797,870 | 6,759,750 | 57.6 | 71.6 | 62.5 | 41.4 |
| Non-CMA areas | 2,916,825 | 1,107,275 | 4,060,300 | 42.4 | 28.4 | 37.5 | 27.3 |
| Total Canada | 6,877,785 | 3,905,145 | 10,820,050 | 100.0 | 100.0 | 100.0 | 36.1 |

* Includes band housing

Source: Clayton Research based on Census of Canada data

**Table 3**

## Occupied Rental Dwellings by Structural Type by Major Market, Canada, 1996

| Census Metropolitan Area (CMA) | Single-Detached | High-Rise Apartment* | All Other | All Types |
|---|---|---|---|---|
| | % of Total by Type | | | |
| St. John's | 11.3 | 2.8 | 85.9 | 100.0 |
| Halifax | 9.5 | 19.3 | 71.2 | 100.0 |
| Saint John | 9.9 | 9.8 | 80.3 | 100.0 |
| Chicoutimi | 6.2 | 3.9 | 89.9 | 100.0 |
| Quebec City | 4.6 | 11.1 | 84.3 | 100.0 |
| Sherbrooke | 5.0 | 5.4 | 89.6 | 100.0 |
| Trois Rivieres | 4.7 | 4.4 | 90.9 | 100.0 |
| Montreal | 3.3 | 14.0 | 82.8 | 100.0 |
| Hull | 10.9 | 13.5 | 75.6 | 100.0 |
| Ottawa | 8.1 | 40.7 | 51.2 | 100.0 |
| Oshawa | 16.0 | 31.8 | 52.3 | 100.0 |
| Toronto | 8.7 | 55.7 | 35.6 | 100.0 |
| Hamilton | 12.6 | 45.6 | 41.8 | 100.0 |
| St. Catharines | 21.7 | 19.6 | 58.7 | 100.0 |
| Kitchener | 8.3 | 25.9 | 65.7 | 100.0 |
| London | 10.2 | 40.9 | 48.8 | 100.0 |
| Windsor | 17.4 | 31.7 | 50.9 | 100.0 |
| Sudbury | 12.0 | 18.4 | 69.7 | 100.0 |
| Thunder Bay | 18.4 | 15.0 | 66.7 | 100.0 |
| Winnipeg | 13.1 | 32.4 | 54.5 | 100.0 |
| Regina | 24.0 | 13.4 | 62.5 | 100.0 |
| Saskatoon | 17.6 | 13.1 | 69.3 | 100.0 |
| Calgary | 16.1 | 18.8 | 65.1 | 100.0 |
| Edmonton | 17.1 | 15.5 | 67.4 | 100.0 |
| Vancouver | 16.7 | 18.7 | 64.6 | 100.0 |
| Victoria | 17.0 | 9.3 | 73.7 | 100.0 |
| Total All CMAs | 9.7 | 27.5 | 62.9 | 100.0 |
| Non-CMA areas | 29.5 | 4.8 | 65.6 | 100.0 |
| Total Canada | 15.3 | 21.1 | 63.6 | 100.0 |

* Units in apartment buildings of 5 or more storeys

Source: Clayton Research based on Census of Canada data

## Levels of Rental Investment Activity

This section looks at the levels of rental investment of various forms, including:

- Development of new private rental units - either through purpose-built rental housing or conversions;
- Sales transactions for existing rental units; and
- Upgrading of the existing rental stock.

### Development of New Rental Units

This section examines the extent of new rental unit development - including units added to the private rental stock through conversion activity.

***Growth in the Total Rental Stock Peaked in the 1960s and 1970s***

The stock of rental units in Canada (both private and assisted combined) grew rapidly during the 1960s and 1970s (at roughly 85,000 units per year), before entering a period of more moderate growth in the 1980s (Figure 3). In the 1990s, average annual growth in the rental stock has fallen off further - at about 40,000 units per year, it is less than half of the growth recorded in the 1960s and 1970s.

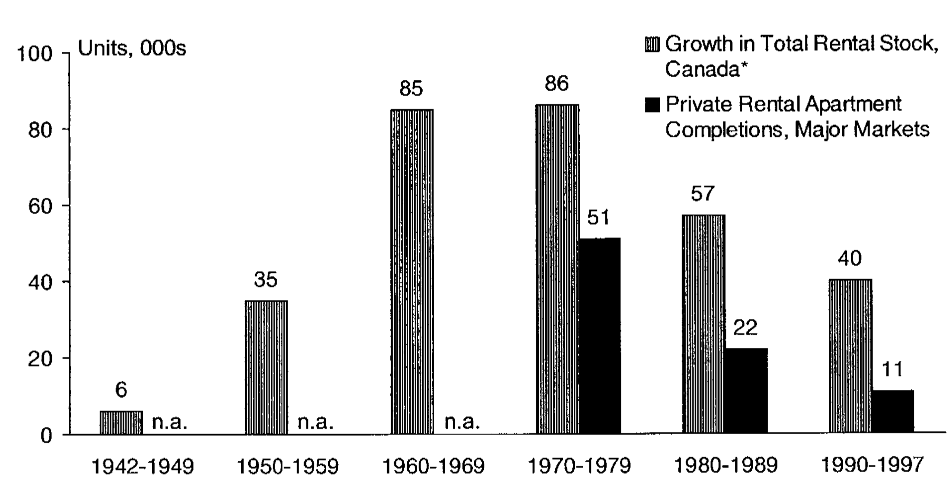
The rapid growth in the 1960s and 1970s was due to a combination of factors.

On the supply-side, as will be discussed later, there were federal government programs and policies in place which encouraged private rental unit development, as well as provided for public/assisted housing.

On the demand-side, the majority of households under 30 years of age rent rather than own (Figure 4). The latter 1960s was the period during which the leading edge of the baby boom generation (that relatively large group of individuals born in the post WWII to mid 1960s period) started to age into the prime renting age groups (Figure 5) - they started to leave their parental homes and enter the rental market.

**Figure 3**

**Average Annual Growth in the Rental Stock, Canada**




* Includes both private and assisted units, all structural types

Source: Clayton Research based on Statistics Canada and CMHC data

**Figure 4**

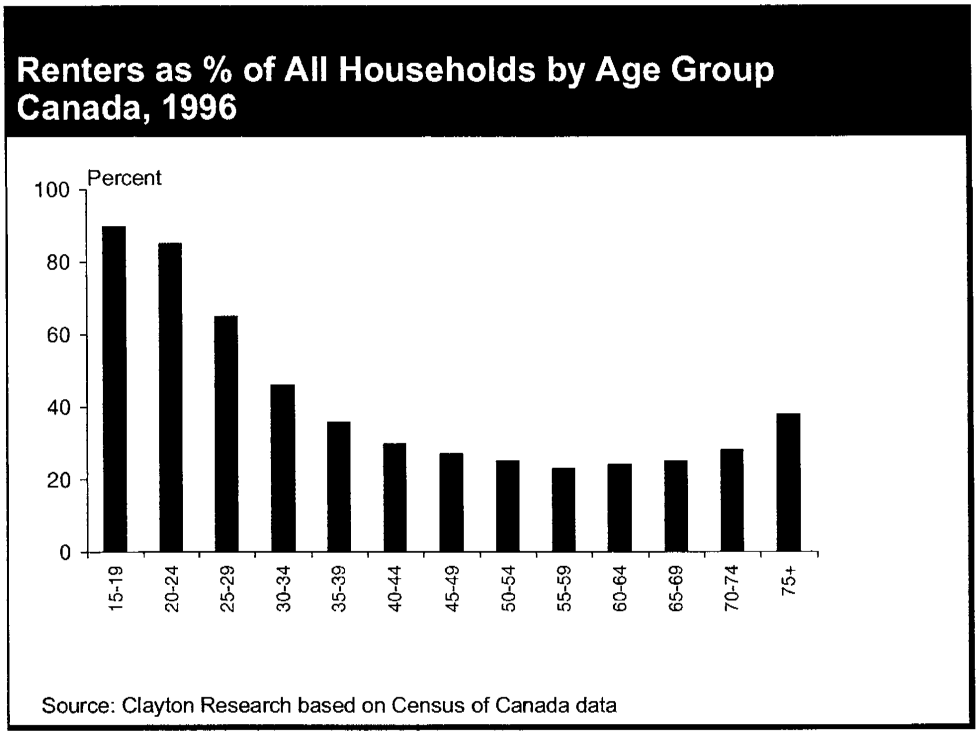
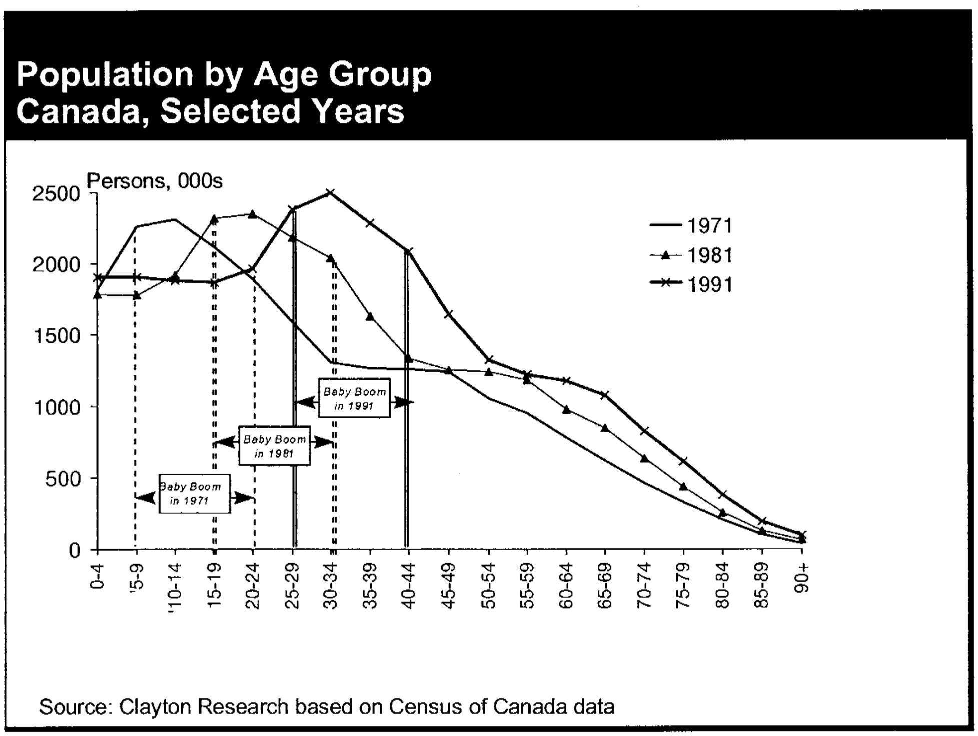



**Figure 5**



### *The Role of Private Rental Apartments Has Been Declining Over the Longer-Term*

Comparable information on longer-term growth in the stock is not available specifically for private rental units. However, there is information related to one subgroup of private rental housing - rental apartments (low-rise and high-rise combined) - which can be examined (Figure 6).

These data confirm the relatively small number of purpose-built private rental apartment units that have been built in recent years compared to the 1970s.

The data also help to illustrate the declining role that private rental apartments have played in the growth in the total rental stock since the 1970s (refer back to Figure 3). In the 1970s, private rental apartments in the major markets accounted for almost 60 percent of the growth in the total rental stock. By the 1980s, however, that share had fallen to 39 percent, and has declined further in the 1990s to 28 percent.

### *Private Rental Unit Development Relatively Stronger in the U.S. Since Mid 1980s*

A comparison of private rental unit development between Canada and the U.S. is shown on Figure 7 and Figure 8. It should be cautioned that, because of differences in how data on housing units built are collected and categorized, a consistent "apples-to-apples" comparison of private rental unit development between Canada and the U.S. is not possible. Nevertheless, the available information is useful in terms of examining broad trends and relationships.

Note that for Canada, the available data cover private rental apartment completions in the 26 major markets.

For the U.S., the data measure completions in the country as a whole which are privately-owned rental units in apartment structures of 5 or more units.

**Figure 6**

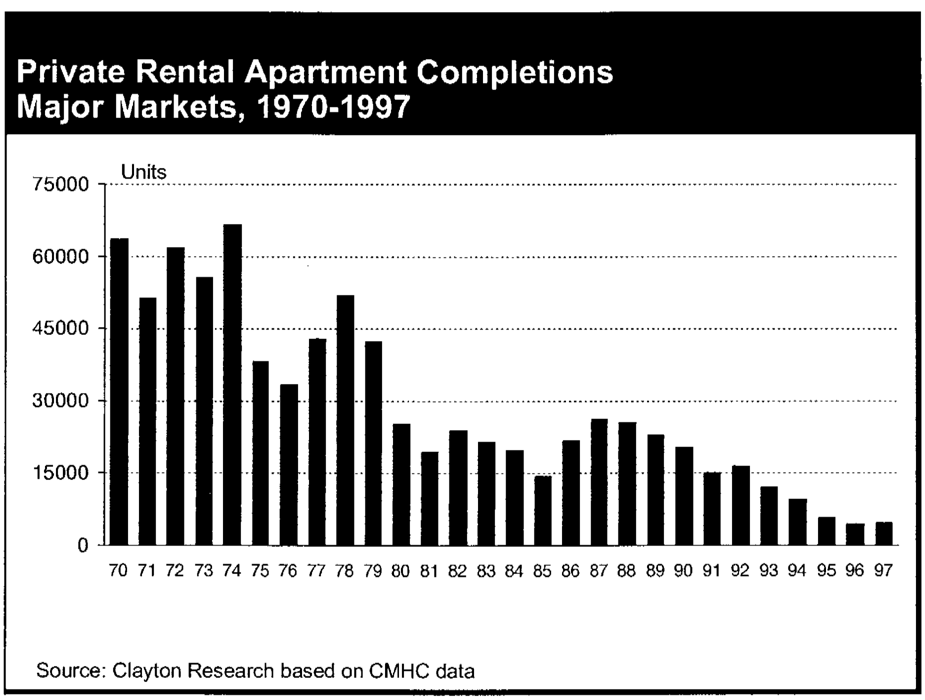
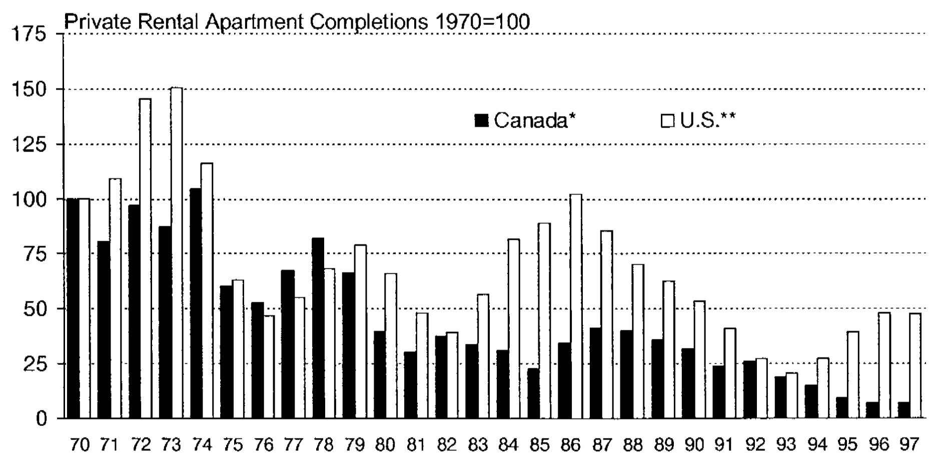


**Figure 7**

## Trends in Private Rental Apartment Development, Canada and U.S., 1970-1997



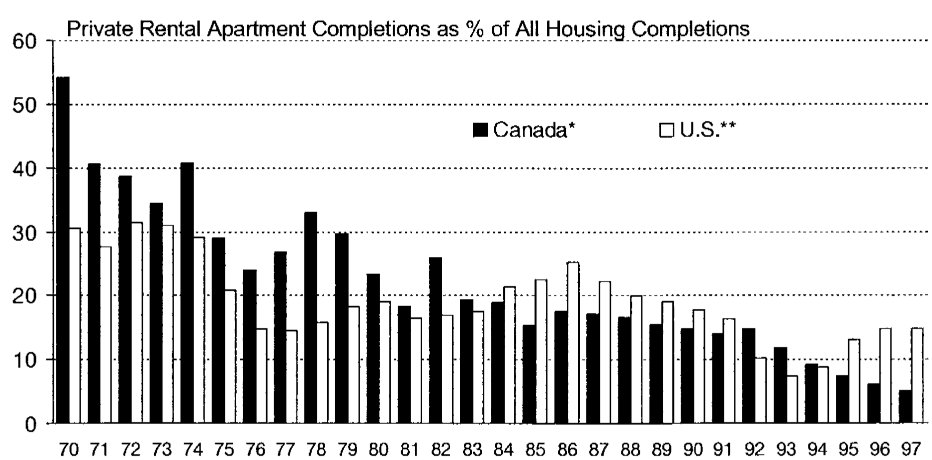

Caution: data for Canada and U.S. not strictly comparable; they are provided here to compare **trends**, not actual levels

* In 26 major markets  ** In all areas; only includes privately owned structures of 5 or more units

Source: Clayton Research based on CMHC and U.S. Department of Commerce data

**Figure 8**

## Relative Importance of Private Rental Apartment Development, Canada and U.S., 1970-1997




Caution: data for Canada and U.S. not strictly comparable; they are provided here to compare **trends**, not actual levels

* In 26 major markets  ** In all areas; only includes privately owned structures of 5 or more units

Source: Clayton Research based on CMHC and U.S. Department of Commerce data

Figure 7 shows that the development of new private rental apartments has stayed more buoyant in the U.S. in the period since the mid 1980s (in relation to the situation in the 1970s and early 1980s) than has been the case in Canada.

The relative shares of total completions which are comprised of private rental apartments has shown mixed patterns since the early 1970s (Figure 8). In the 1970s and early 1980s, private rental apartments were a relatively more important contributor to new housing supply in Canada than the U.S. In the period since, however, this relative pattern has reversed.

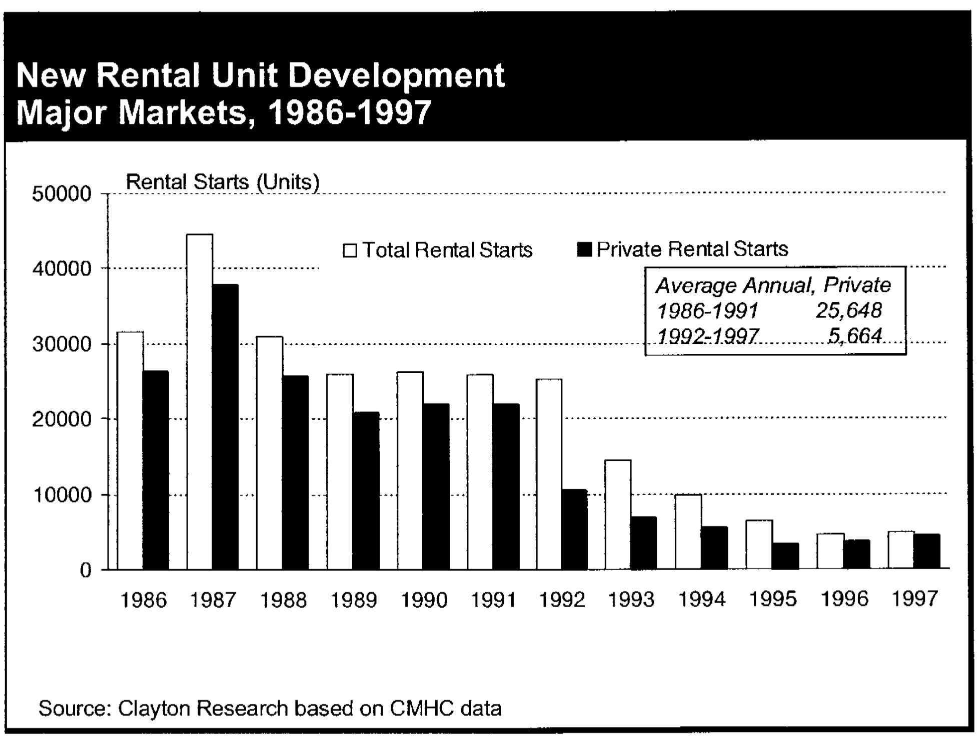
The factors which have played a role in relatively stronger levels of new private rental apartment development in the U.S. versus Canada are discussed in Chapter 3.

### *Mixed Trends in New Rental Unit Development by Major Market in the 1990s*

Since 1986, there has been a dramatic fall-off in private rental starts in Canada's major markets - from an average of over 25,000 units per year in the 1986-1991 period, to less than 6,000 units per year in the 1992-1997 period (Figure 9).

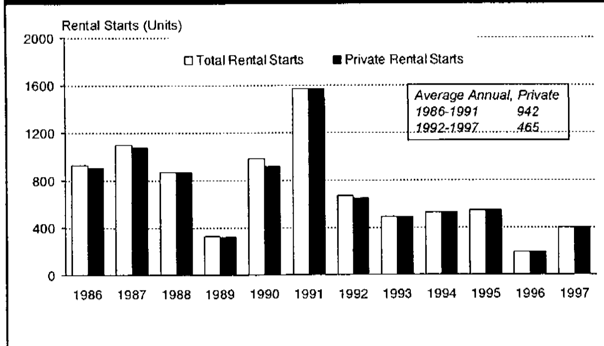
However, the patterns have not necessarily been consistent in all markets, as shown by information for the six markets selected for special analysis in this study (as provided on Figure 10 through Figure 15).

**Figure 9**



## Figure 10

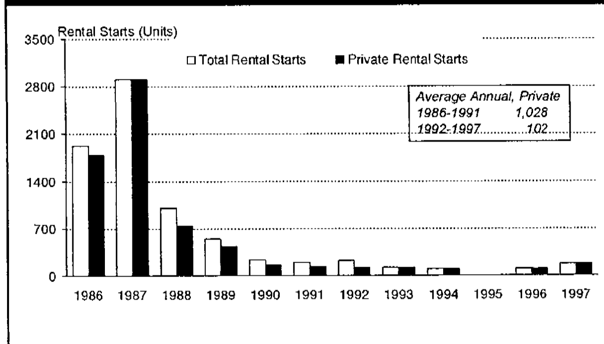
**New Rental Unit Development**
**Halifax, 1986-1997**




Source: Clayton Research based on CMHC data

## Figure 13

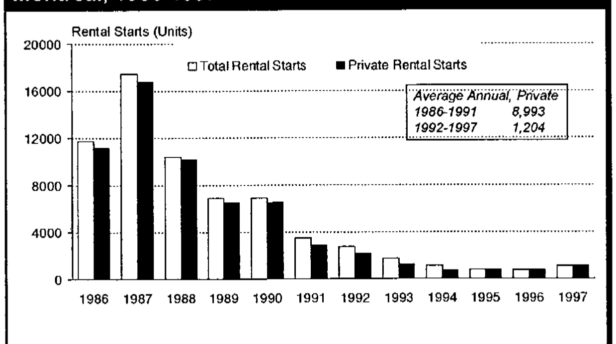
**New Rental Unit Development**
**Winnipeg, 1986-1997**




Source: Clayton Research based on CMHC data

## Figure 11

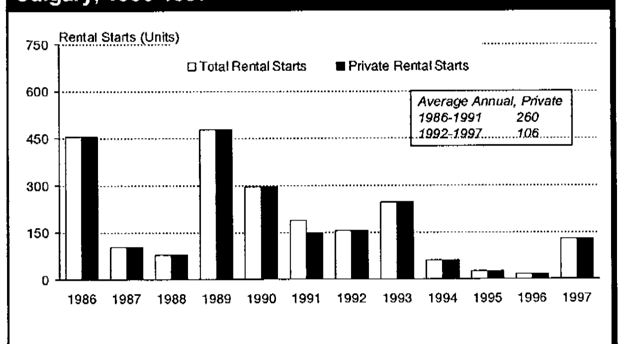
**New Rental Unit Development**
**Montreal, 1986-1997**




Source: Clayton Research based on CMHC data

## Figure 14

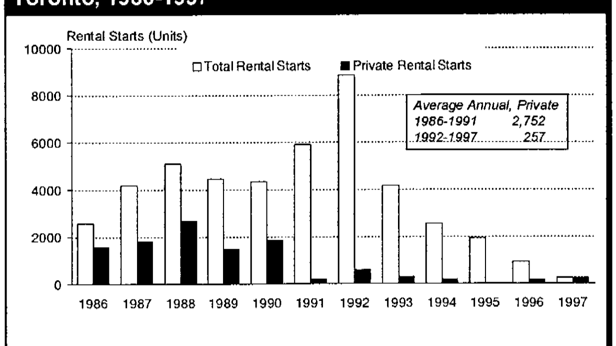
**New Rental Unit Development**
**Calgary, 1986-1997**




Source: Clayton Research based on CMHC data

## Figure 12

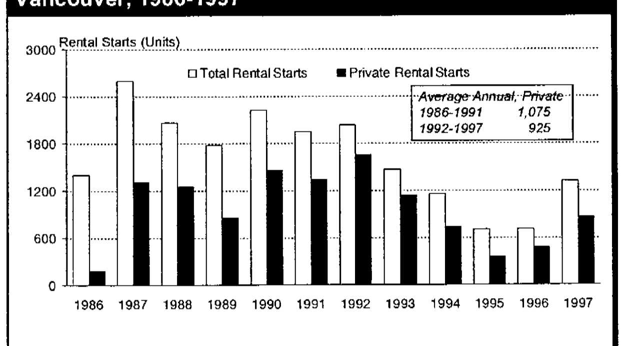
**New Rental Unit Development**
**Toronto, 1986-1997**




Source: Clayton Research based on CMHC data

## Figure 15

**New Rental Unit Development**
**Vancouver, 1986-1997**




Source: Clayton Research based on CMHC data

- In **Halifax**, development of new private rental units has been relatively buoyant in recent years. Although down from the recent peak in 1991, activity has still averaged roughly 400-500 units per year since 1992.
- In **Montreal,** construction of private rental units has declined dramatically in the 1990s from the relatively buoyant levels of the latter 1980s, although it remains the top major market for new private rental unit development.
- In **Toronto**, private rental unit development has virtually disappeared in the 1990s, although there was a substantial number of assisted housing units built in the latter 1980s and early 1990s.
- In **Winnipeg,** there has been little new private rental unit development in the 1990s; this follows a period of relative buoyancy in the latter 1980s.
- In **Calgary,** only a few hundred new rental units have been developed in the 1990s; the numbers in the latter 1980s were not much higher.
- In **Vancouver**, there has been a more stable pattern of private rental unit development since the mid 1980s, averaging roughly 1,000 units per year. As well, of the six markets examined here, Vancouver is the only market, besides Toronto, to have any substantial amounts of assisted rental unit development.

### *Converted Rental Housing Has Helped to Fill the Supply Gap*

The gap in new purpose-built private rental supply has been addressed by a variety of other types of rental housing - including both assisted units and converted units (single-family homes and condominiums being rented out by their owners, and secondary suites/accessory apartments).

There is no comprehensive information available on the extent to which conversion activity takes place. However, rough estimates for the 1991-1996 period were prepared by Clayton Research for the six major markets being reviewed based on a consideration of total growth in the rental stock, construction of purpose-built rental units and changes in vacancy rates.

**Figure 16**

**Estimated Net Conversion Activity Selected Major Markets, 1991-1996**

| | |
|---|---|
| Halifax | No net change over period |
| Montreal | Net gain of 2,000-3,000 units per year |
| Toronto | Net gain of 3,000-4,000 units per year |
| Winnipeg | Net loss of 500-600 units per year |
| Calgary | Net loss of 1,000-1,500 units per year |
| Vancouver | Net gain of 2,000-3,000 units per year |

Source: Clayton Research based on Census of Canada and CMHC data

The data on Figure 16 show that converted units were an important source of new rental supply in Toronto, Montreal and Vancouver in the first half of the 1990s. In Winnipeg and Calgary, however, high vacancy rates and, in the case of Calgary, conversion of rental units to condominium tenure, removed units from the rental stock. In Halifax, there was no net gain - or loss - to the rental stock from converted units over this period.

Whether or not converted units have entirely made up the supply gap left by low levels of private rental construction is unclear. Relatively high rental vacancy rates in many centres suggest that this may be the case, although temporarily weak local economic conditions, and very favourable homeownership affordability, have also played a significant role in higher vacancy rates in the 1990s.

### Sales of Existing Rental Properties

This section examines the extent of activity in sales/purchases of existing rental buildings.

***Sales Activity for Existing Rental Properties Has Surged in Recent Years***

Unfortunately, unlike new rental unit development, which CMHC tracks on a comprehensive basis, there is no comparable comprehensive data available on sales of rental properties.

One source of partial information, however, is CMHC's mortgage insurance underwriting data base. From this data base, information has been compiled specifically for this study on purchases of existing buildings which involved CMHC mortgage insurance. While this represents only a portion of the total market, the information is useful in examining recent trends in sales of existing rental properties, as well as the composition of these sales. Discussions with lenders, as well as information on both insured and non-insured activity in selected markets, suggests that CMHC insured activity may represent roughly half of all sales activity overall, although there are likely variations by market.

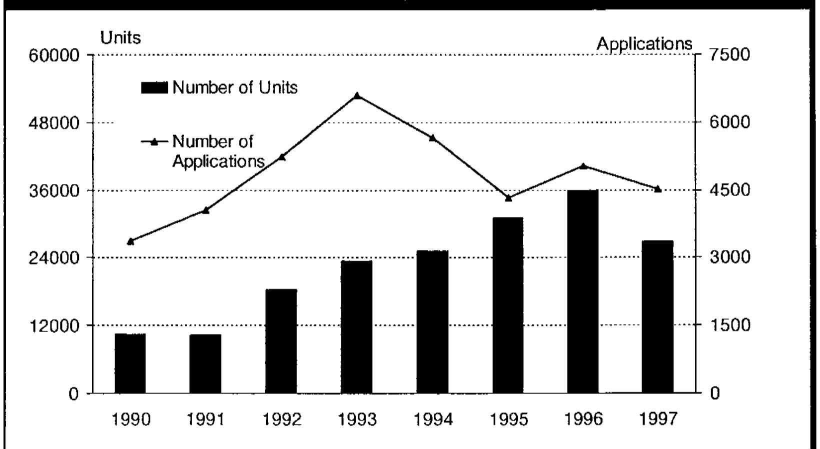
The level of sales activity in existing rental buildings where CMHC insurance was obtained has picked up substantially since the early 1990s (Figure 17) - at least in terms of the number of units involved. The number of transactions has remained more stable - in other words, there has been a shift to larger transactions.

The growth in CMHC insured activity since the early 1990s likely reflects both the general increase in purchases of existing rental properties, as well as some increase in the share of all transactions which are insured. Unfortunately, comprehensive data on transactions which did not involve CMHC insurance is not available to confirm this latter point.

Similarly the decline in activity shown for 1997 is likely not representative of the situation in the total market (i.e. both insured and uninsured sales). For example, as shown later, comprehensive data compiled by Fish Marks on all larger transactions in the Toronto area (where the largest share of activity has occurred in recent years) shows increased activity in 1997. As seen in a later section, CMHC insurance premiums were raised in 1996, which may have impacted demand for the product in 1997.

**Figure 17**

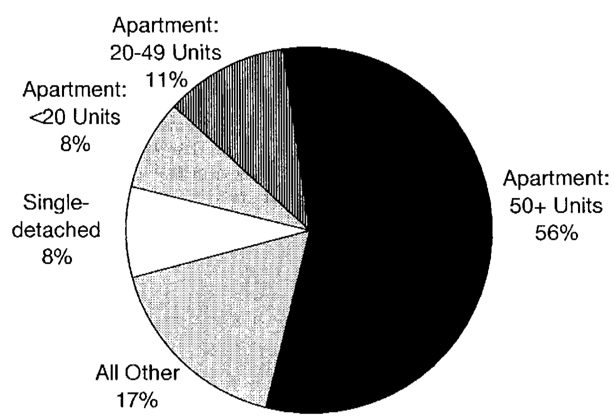
**Existing Rental Units Purchased by Year**
**CMHC Insured Transactions, Canada, 1990-1997**




Source: Clayton Research based on CMHC data

**Figure 18**

**Existing Rental Units Purchased by Type**
**CMHC Insured Transactions, Canada, 1997, % of Units**




Source: Clayton Research based on CMHC data

Putting the sales levels in perspective, the roughly 27,000 units which were bought in 1997 using CMHC insurance represents about 0.7 percent of the total rental stock in 1996. Assuming that CMHC insured activity represents roughly half of all activity, this suggests that between 1 and 2 percent of the private rental stock is trading hands each year.

### *Sales Focused in Larger Apartment Buildings*

Focusing in on the composition of sales in 1997, just over half of the units purchased that involved CMHC insurance were part of large transactions involving 50 or more apartment units (Figure 18). Another 19 percent were apartment unit transactions of less than 50 units - this group would include low-rise apartment buildings, as well as investor-owned condominium apartment units. A significant portion (about one-quarter) were single-detached units or "other" types of units - including semi-detached, townhouse and plexes.

### *Montreal, Toronto and Edmonton Recorded the Strongest Activity in 1997*

The top three markets in 1997 for sales of existing rental properties were Montreal, Toronto and Edmonton (Table 4). Together, these 3 centres accounted for half of units sold which involved CMHC insurance, and two-thirds of units in larger apartment building transactions.

In relation to the total rental stock, recent sales activity which involved CMHC insurance has been relatively stronger in the major markets in Atlantic Canada, Saskatchewan and Alberta, as well as Kitchener, Ontario.

### *Some Differences in Trends by Major Market*

A time series on CMHC insured transactions was also compiled for the selected 6 major markets (Figure 19 through Figure 24). These show that in general, CMHC insured transactions have been higher in recent years compared to the first half of the 1990s. More recently, Toronto, Calgary and Montreal have been more buoyant while activity in Halifax and Winnipeg has remained flat, and in Vancouver, has declined.

**Table 4**

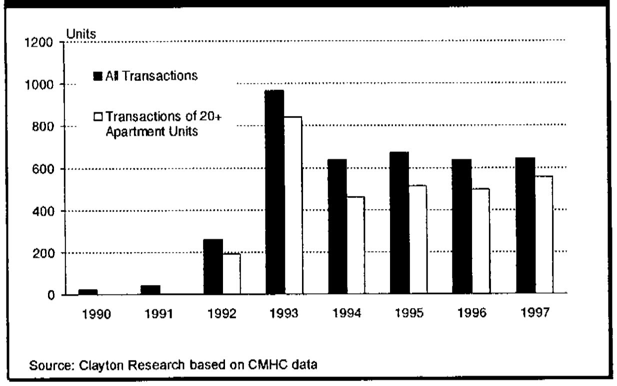
## Existing Rental Units Purchased by Major Market CMHC Insured Transactions, 1997

| Census Metropolitan Area (CMA) | Number of Units | | Percent of Canada Total | | All Transactions as % of Total Rental Stock in 1996 |
|---|---|---|---|---|---|
| | All Transactions | Apartments of 20 or More Units | All Transactions | Apartments of 20 or More Units | |
| St. John's | 201 | 108 | 0.7 | 0.6 | 1.0 |
| Halifax | 643 | 554 | 2.4 | 3.1 | 1.3 |
| Saint John | 256 | 205 | 1.0 | 1.1 | 1.6 |
| Chicoutimi | 129 | 0 | 0.5 | 0.0 | 0.5 |
| Quebec City | 668 | 546 | 2.5 | 3.1 | 0.5 |
| Sherbrooke | 272 | 205 | 1.0 | 1.1 | 0.9 |
| Trois Rivieres | 68 | 0 | 0.3 | 0.0 | 0.3 |
| Montreal | 5,924 | 4,372 | 22.1 | 24.5 | 0.9 |
| Hull | 180 | 31 | 0.7 | 0.2 | 0.5 |
| Ottawa | 292 | 223 | 1.1 | 1.3 | 0.2 |
| Oshawa | 14 | 0 | 0.1 | 0.0 | 0.1 |
| Toronto | 4,888 | 4,443 | 18.2 | 24.9 | 0.8 |
| Hamilton | 186 | 130 | 0.7 | 0.7 | 0.2 |
| St. Catharines | 328 | 274 | 1.2 | 1.5 | 0.8 |
| Kitchener | 772 | 465 | 2.9 | 2.6 | 1.5 |
| London | 450 | 188 | 1.7 | 1.1 | 0.7 |
| Windsor | 185 | 83 | 0.7 | 0.5 | 0.6 |
| Sudbury | 112 | 35 | 0.4 | 0.2 | 0.5 |
| Thunder Bay | 27 | 0 | 0.1 | 0.0 | 0.2 |
| Winnipeg | 481 | 332 | 1.8 | 1.9 | 0.5 |
| Regina | 325 | 144 | 1.2 | 0.8 | 1.3 |
| Saskatoon | 608 | 432 | 2.3 | 2.4 | 1.9 |
| Calgary | 1,119 | 637 | 4.2 | 3.6 | 1.1 |
| Edmonton | 2,942 | 2,456 | 11.0 | 13.8 | 2.6 |
| Vancouver | 299 | 197 | 1.1 | 1.1 | 0.1 |
| Victoria | 282 | 236 | 1.1 | 1.3 | 0.6 |
| Total All CMAs | 21,651 | 16,296 | 80.7 | 91.4 | 0.8 |
| Non-CMA areas | 5,181 | 1,536 | 19.3 | 8.6 | 0.5 |
| Total Canada | 26,832 | 17,832 | 100.0 | 100.0 | 0.7 |

Source: Clayton Research based on CMHC data

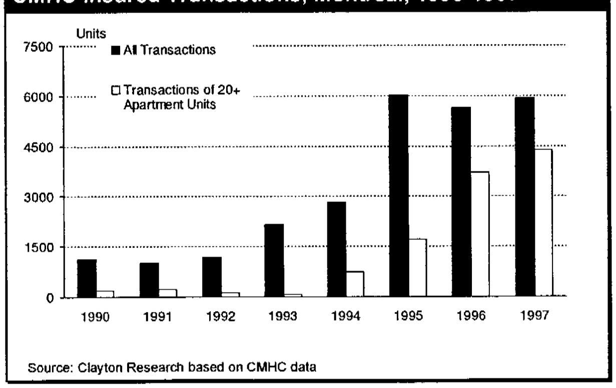
## Figure 19

**Existing Rental Units Purchased by Year**
**CMHC Insured Transactions, Halifax, 1990-1997**



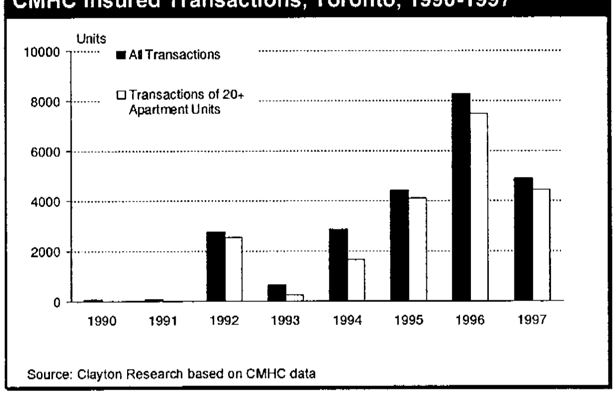

## Figure 20

**Existing Rental Units Purchased by Year**
**CMHC Insured Transactions, Montreal, 1990-1997**



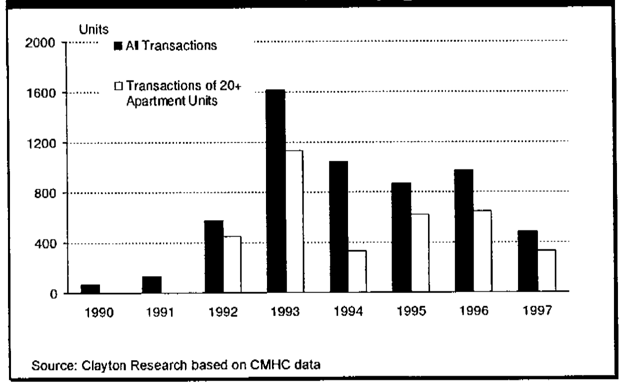

## Figure 21

**Existing Rental Units Purchased by Year**
**CMHC Insured Transactions, Toronto, 1990-1997**



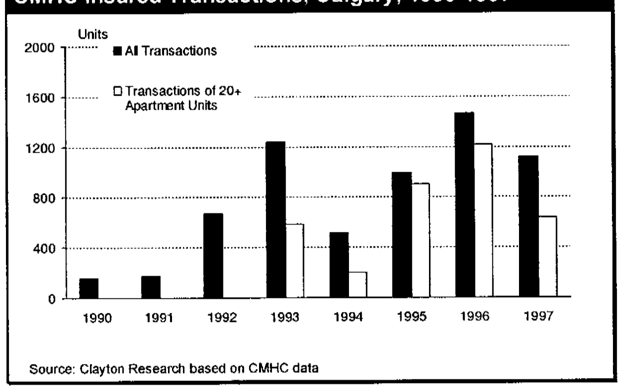

## Figure 22

**Existing Rental Units Purchased by Year**
**CMHC Insured Transactions, Winnipeg, 1990-1997**



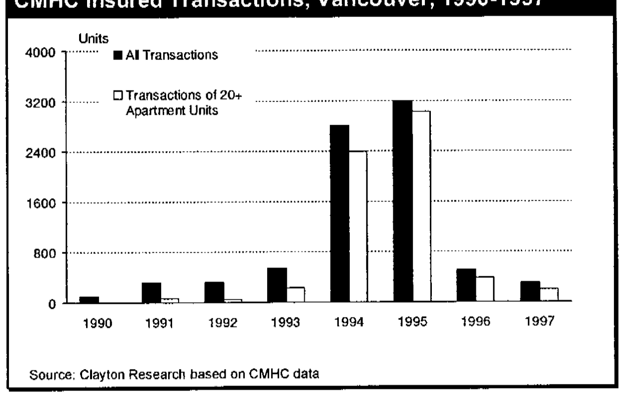

## Figure 23

**Existing Rental Units Purchased by Year**
**CMHC Insured Transactions, Calgary, 1990-1997**




## Figure 24

**Existing Rental Units Purchased by Year**
**CMHC Insured Transactions, Vancouver, 1990-1997**



### *No Single Data Series Provides a Comprehensive Picture of Resale Activity*

The CMHC insurance underwriting data base information was supplemented by data compiled specifically for this project by Fish Marks Jenkins and its affiliates in various centres across Canada, as well as data provided by Colliers.

A comparison of sales data for 1997 from the three sources - CMHC's insurance underwriting data base, Fish Marks Jenkins and Colliers - is shown in Table 5. Note that the degree of the comprehensiveness of the Fish Marks Jenkins and Colliers information varies by market area in terms of its timeframe, coverage and completeness. The key advantage of these data, however, are that they cover both transactions which did involve CMHC insurance, as well as those that did not.

For all markets except Montreal, the data confirm that CMHC activity only covers a portion of the market. In Montreal, the relatively higher numbers on insured activity reflect the less comprehensive degree of coverage by the Fish Marks Jenkins and Colliers data.

**Table 5**

**Comparison of Existing Rental Unit Transactions from Alternate Sources Selected Major Markets, 1997**

| Major Market | CMHC Insured Transactions Apartments of 20 or More Units | Fish Marks Jenkins Larger Transactions* | Colliers Larger Transactions* |
|---|---|---|---|
| | *Units* | | |
| Halifax | 554 | 1,343 | 750 |
| Montreal | 4,372 | 3,883 | 3,041 |
| Toronto | 4,443 | 18,031 | 14,129 |
| Winnipeg | 332 | na | 854 |
| Calgary | 637 | na | 4,048 |
| Vancouver | 197 | 315 | 743 |

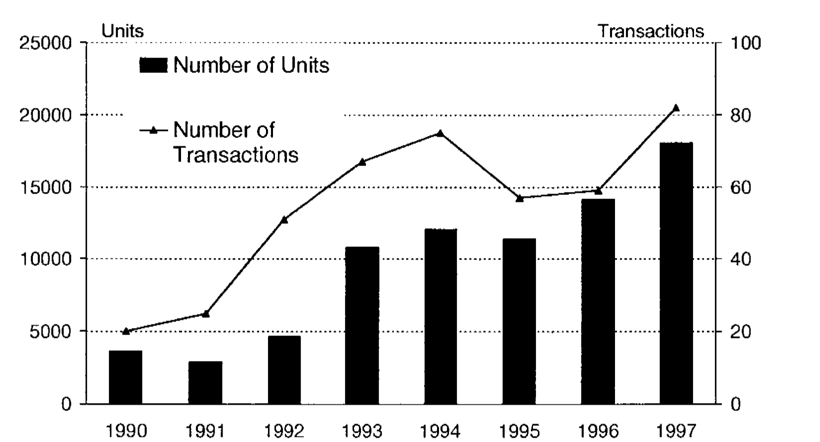
* Generally 20 or more units; includes both insured and uninsured activity

Source: Clayton Research based on data from CMHC, Fish Marks Jenkins and Colliers

A time series of data for Toronto, the market for which the most comprehensive information is available, is provided in Figure 25. As indicated earlier, this data, unlike the CMHC data, suggest that sales of existing units in Toronto continued to increase through 1997.

**Figure 25**

**Existing Rental Building Transactions by Year* Toronto, 1990-1997**




* Includes both insured and uninsured activity
Source: Clayton Research based on Fish Marks Jenkins data

## Upgrading of Existing Rental Properties

This section examines the extent of investment in upgrading existing rental properties.

### *New Data Help to Fill An Important Information Gap*

Until recently, there was very little information available on renovation spending on private rental dwellings.

In 1996, however, CMHC commissioned Statistics Canada to undertake a survey of landlords called **The Rental Repair and Renovation Expenditure Survey**. The survey covered investment by private sector landlords in upgrading their rental units in the year 1995. Both maintenance and repair work, as well as renovations and alterations, were covered. Clayton Research was commissioned by CMHC to analyze the results on its behalf.

Highlights of the information include:

- **Total spending**: An estimated $3.8 billion was spent by landlords on repairs and renovations to private rental units in 1995 (Figure 26). About 4 out of every 10 dollars was spent on repairs and maintenance.
- **Incidence of work**: The vast majority - over 80 percent - of private rental units had some type of repair and renovation done on them in 1995 (Figure 27). The most common type of work was on-going repairs and maintenance. Least common were additions.
- **Average spending**: The average amount spent per unit (including those with zero expenditures) on all types of repairs and renovations was just over $1,200 (Figure 28). Focusing on only those units which had spending, the average was between $1,400 and $1,500.
- **Variation by region**: The average amounts spent per unit were higher in Ontario and the Prairie Provinces (Figure 29). When average amounts spent on repairs and renovations are compared to average rents, landlords in B.C. and Ontario appear to be spending a relatively smaller share of income on repairs and renovations, and landlords in the Atlantic Region and the Prairie Provinces relatively more.[4]
- **Extent of work**: Only a small proportion of units underwent renovations of $5,000 or more per unit - however, this group accounted for over one-third of total repair and renovation spending on private rental units.
- **Variation by dwelling type**: Average spending per unit is highest for single-detached units, and lowest for low-rise apartments (Figure 30). This likely reflects the relative size of different dwelling types, with larger expenditures on average being required for units with more space.
- **Variation by age**: Average spending on rental repairs and renovations was significantly higher for units that were at least 25 years old - that is, built before 1970 (Figure 31).

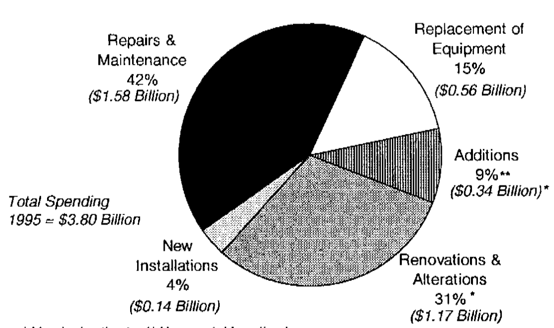
### *Trend Analysis Not Available*

Unfortunately, as the survey is only as of one point in time, it is not possible to show any changes over time. Nor is comparable information expected to be available for the future.[5]

[4] Data are only available on a regional basis (i.e. no information is available at a major market level).
[5] At present, there are no plans to repeat the survey as conducted for 1995. Instead, Statistics Canada plans to collect information on repairs and renovations to rental buildings as part of the new **Survey of Real Estate Rental & Leasing and Property Management Industries**. This survey will collect a range of information on these industries, and the information specific to repairs and renovations to rental buildings will be less comprehensive than that collected on the Rental Repair and Renovation Expenditure Survey.

## Figure 26

**Total Repair and Renovation Spending On Private Rental Units by Type of Work, Canada, 1995**




* Marginal estimate ** Unacceptable estimate

Source: The Rental Repair and Renovation Expenditure Survey, 1995

## Figure 29

**Comparison of Average Landlord Spending on Repairs and Renovations on Private Rental Units and Average Rents by Region**

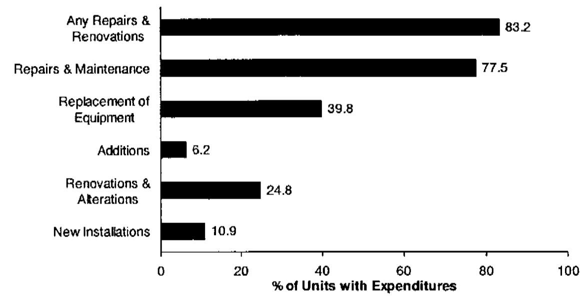
| Region | Average Repair & Renovation Spending Per Unit, 1995 | Annualized Average Gross Rent May 1996* | Ratio of Repair & Renovation Spending to Avg. Rent |
|---|---|---|---|
| Atlantic | $1,132 | $6,087 | 0.19 |
| Quebec | $1,059 | $6,072 | 0.17 |
| Ontario | $1,342 | $8,148 | 0.16 |
| Prairies | $1,373 | $6,214 | 0.22 |
| B.C. | $1,090 | $8,448 | 0.13 |
| Canada | $1,209 | $7,140 | 0.17 |

* Includes both privately and publicly owned units

Source: The Rental Repair and Renovation Expenditure Survey 1995, and 1996 HIFE microdatafile

## Figure 27

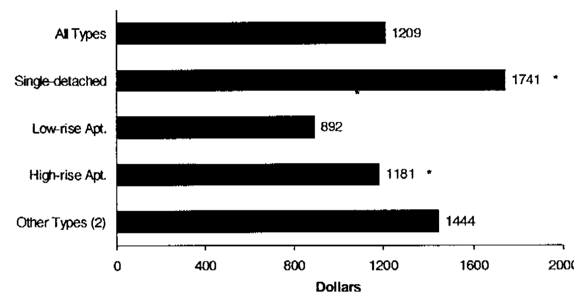
**Incidence of Repair and Renovation Spending On Private Rental Units by Type of Work, Canada, 1995**




Source: The Rental Repair and Renovation Expenditure Survey, 1995

## Figure 30

**Average(1) Repair and Renovation Spending Per Private Rental Unit by Structural Type, Canada, 1995**

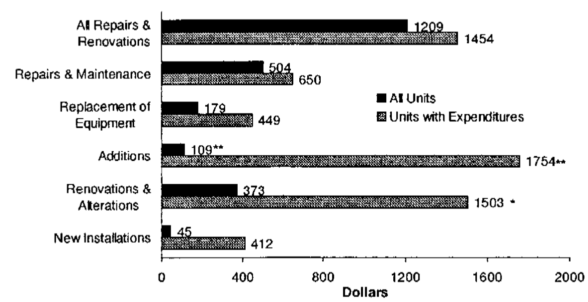



(1) Average for all units (i.e. those with and without expenditures)
(2) Includes double, row, duplex, mobile and any other types not elsewhere classified
* Marginal estimate

Source: The Rental Repair and Renovation Expenditure Survey, 1995

## Figure 28

**Average Repair and Renovation Spending Per Private Rental Unit by Type of Work, Canada, 1995**

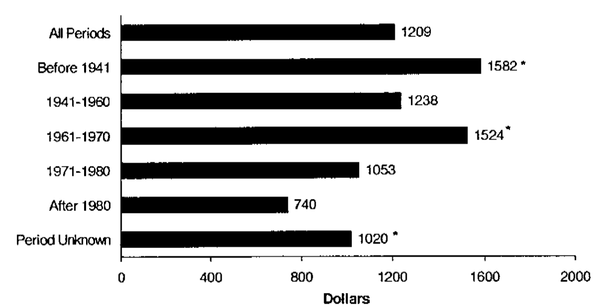



* Marginal estimate ** Unacceptable estimate

Source: The Rental Repair and Renovation Expenditure Survey, 1995

## Figure 31

**Average(1) Repair and Renovation Spending Per Private Rental Unit by Period Constructed, Canada, 1995**




(1) Average for all units (i.e. those with and without expenditures)
* Marginal estimate

Source: The Rental Repair and Renovation Expenditure Survey, 1995

## The Nature and Extent of Private Rental Housing Investment - Summary of Key Findings

- There are about 4 million rental housing units in Canada, the majority of which are owned by the private sector.
- The stock of rental units in Canada grew rapidly during the 1960s and 1970s before entering a period of more moderate growth in the 1980s and falling further in the 1990s.
- Purpose-built private rental units have played a declining role in the growth in the total rental stock since the 1970s.
- The gap has been made up by a variety of other types of rental housing - including social/assisted units and converted units (single-family homes and condominiums being rented out by their owners, and secondary suites/accessory apartments).
- Investment in new purpose-built private rental units has been relatively low in recent years. Only about 6,000 new units per year have been developed since 1992 in Canada's major markets - this is less than one-quarter of the levels built in the 1986-1991 period.
- But interest in the existing rental stock has picked up in recent years. While comprehensive information on total sales activity is not available, sales transactions have been more buoyant in recent years compared to the first part of the 1990s, in particular in Toronto, Montreal and Edmonton.
- There is also investment occurring in the upkeep and upgrading of existing private rental units. Landlords in Canada in total spent almost $4 billion on repairs and renovations to private rental units in 1995 - or approximately $1,200 per unit.

# CHAPTER 3 - THE ENVIRONMENT FOR PRIVATE RENTAL HOUSING INVESTMENT IN THE 1990s

This chapter examines the environment for investment in private rental housing in the 1990s. The main purpose of the chapter is to provide readers with the necessary background and context for the subsequent development of a profile of rental investors and the examination of the economics of new private rental housing.

The chapter begins with a look at the environment for private rental investment from a market, or "internal", perspective. Specifically, it briefly reviews recent and current rental market conditions.

This is followed by a brief discussion of some of the key "external" factors which can have a direct impact on the rental investment decision but which are not controllable by the investor - such factors as government programs to stimulate rental construction, financing and lender/mortgage insurer policies, rent control and landlord tenant legislation, taxation, and other government-imposed costs.

## Current Rental Market Conditions

This section looks at recent trends and current private rental market conditions

### Rental Vacancy Rates Have Been Relatively High Since the Early 1990s

Vacancy rates started to increase in the latter 1980s (Figure 32). The overall vacancy rate in private rental apartments of 6 or more units for all major markets has averaged just over 4 percent in the past 10 years (Table 6), roughly double the average of just over 2 percent in the 1979-1988 period

However, the situation is improving. Over the past year, the vacancy rate has fallen from 4.1 percent to 3.4 percent - still somewhat above the longer term 20 year average of 3.1 percent.

**Figure 32**

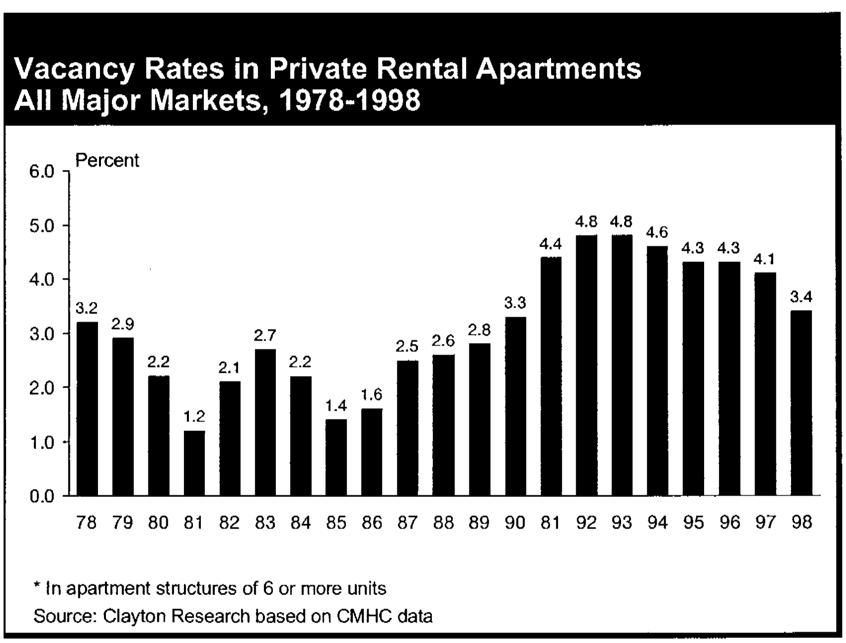


**Table 6**

**Vacancy Rates and Average Rents by Major Market**

| Census Metropolitan Area (CMA) | Vacancy Rates* | | | | | Average Monthly Rents | | |
|---|---|---|---|---|---|---|---|---|
| | October 1997 | October 1998 | Average 1979-1988 | Average 1989-1998 | Average Past 20 Years | Census 1996** | CMHC October 1998* 1 Bedroom | CMHC October 1998* 2 Bedroom |
| | *Percent* | | | | | *Dollars* | | |
| St. John's | 17.4 | 16.3 | 3.5 | 9.6 | 6.6 | 532 | 484 | 520 |
| Halifax | 8.2 | 5.5 | 1.8 | 6.2 | 4.0 | 598 | 517 | 636 |
| Saint John | 8.6 | 8.0 | 3.7 | 6.7 | 5.2 | 450 | 395 | 458 |
| Chicoutimi | 4.6 | 5.3 | 4.4 | 6.2 | 5.3 | 452 | 377 | 454 |
| Quebec City | 6.5 | 5.1 | 3.6 | 6.1 | 4.9 | 506 | 460 | 528 |
| Sherbrooke | 8.1 | 8.2 | n.a. | 8.8 | n.a. | 459 | 371 | 436 |
| Trois Rivieres | 8.8 | 8.3 | n.a. | 7.8 | n.a. | 440 | 361 | 421 |
| Montreal | 6.6 | 5.2 | 2.9 | 6.8 | 4.8 | 542 | 454 | 512 |
| Hull | 8.9 | 5.9 | 4.5 | 5.9 | 5.2 | 551 | 468 | 539 |
| Ottawa | 4.0 | 2.0 | 1.4 | 2.3 | 1.9 | 706 | 617 | 757 |
| Oshawa | 2.3 | 2.0 | 1.0 | 3.0 | 2.0 | 684 | 645 | 732 |
| Toronto | 0.8 | 0.8 | 0.5 | 1.2 | 0.8 | 758 | 730 | 879 |
| Hamilton | 3.1 | 3.1 | 0.7 | 2.0 | 1.4 | 623 | 543 | 665 |
| St. Catharines | 4.8 | 4.5 | 1.0 | 3.8 | 2.4 | 582 | 535 | 633 |
| Kitchener | 1.9 | 1.4 | 0.7 | 2.5 | 1.6 | 627 | 549 | 644 |
| London | 4.9 | 4.4 | 2.2 | 4.0 | 3.1 | 623 | 522 | 646 |
| Windsor | 4.5 | 4.0 | 2.4 | 2.6 | 2.5 | 595 | 581 | 705 |
| Sudbury | 6.9 | 8.3 | 1.4 | 3.8 | 2.6 | 559 | 532 | 641 |
| Thunder Bay | 7.3 | 7.9 | 1.1 | 3.8 | 2.4 | 569 | 545 | 665 |
| Winnipeg | 5.8 | 3.9 | 2.6 | 5.8 | 4.2 | 507 | 455 | 577 |
| Regina | 1.5 | 1.7 | 2.2 | 3.4 | 2.8 | 491 | 437 | 529 |
| Saskatoon | 0.9 | 0.8 | 2.5 | 3.5 | 3.0 | 483 | 427 | 517 |
| Calgary | 0.5 | 0.5 | 4.2 | 3.0 | 3.6 | 602 | 578 | 722 |
| Edmonton | 4.6 | 1.9 | 4.6 | 5.0 | 4.8 | 539 | 450 | 552 |
| Vancouver | 1.5 | 2.7 | 1.0 | 1.3 | 1.2 | 754 | 677 | 869 |
| Victoria | 3.5 | 3.8 | 0.8 | 2.2 | 1.5 | 716 | 570 | 721 |
| Total All CMAs | 4.1 | 3.4 | 2.1 | 4.1 | 3.1 | 595 | n.a. | n.a. |

* Privately initiated apartment structures of six or more units ** All rental units (private and assisted)

Source: Clayton Research based on data from CMHC and Census of Canada

In general, a vacancy rate in the 2-3 percent range is considered to be indicative of a balanced market (the "normal" rate may vary by centre, depending on the proportion of the total rental stock that is not covered by the CMHC survey). A vacancy rate above this threshold indicates a "soft" or oversupplied market, and below this a "tight" or undersupplied market.

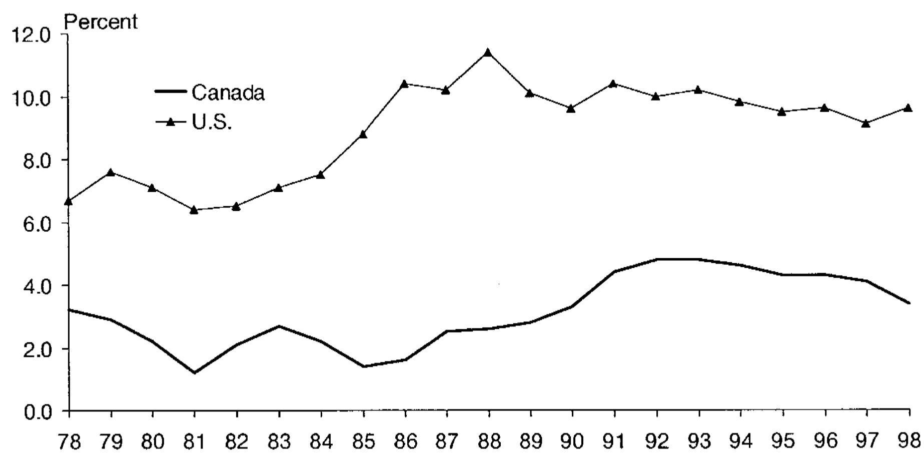
Vacancy rates are currently "excessive" (i.e. above 3 percent) in the majority of major markets in Canada. At present, the tightest markets are Calgary, Toronto and Saskatoon - in each of these markets, the vacancy rate is less than 1 percent.

### U.S Vacancy Rates Also High in Historical Terms

A direct comparison of the level of vacancy rates between Canada and the U.S. is not possible, due to definitional and coverage difference. However, the prevailing series for each country can be used to look at the trends in rates over the past 20 years (Figure 33).

**Figure 33**

**Vacancy Rates in Private Rental Apartments Canada and U.S.*, 1978-1998**




* Caution: data for Canada and U.S. not strictly comparable; they are provided here to compare **trends**, not actual levels

Source: Clayton Research based on data from CMHC and the U.S.Department of Commerce

The comparison shows that vacancy rates started to rise much sooner in the U.S. than Canada (i.e. in the mid 1980s rather than the latter 1980s). but similar to Canada, they have remained persistently high in historical terms through the 1990s.

### Both Supply and Demand Factors Have Contributed to High Vacancy Rates

Vacancy rates and rents reflect the interaction between demand and supply.

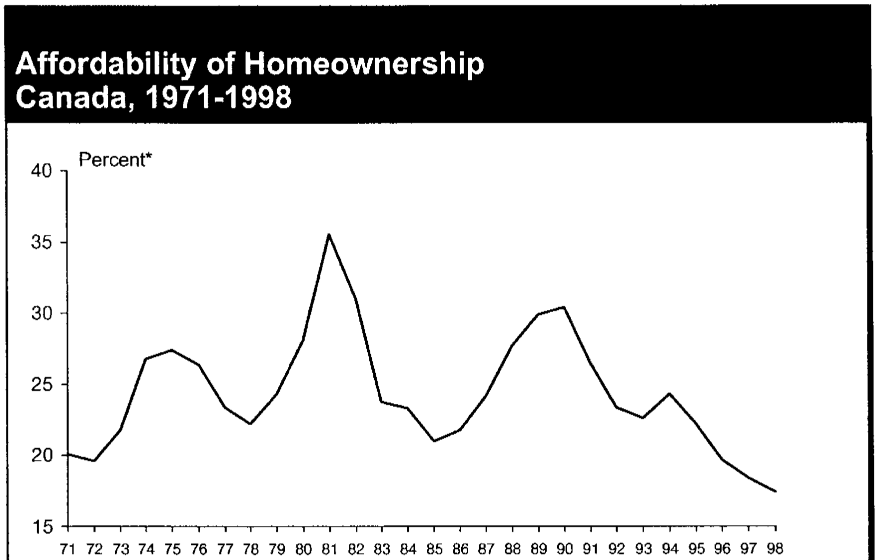
On the supply side (as was shown in Chapter 2), there have been relatively few new rental units constructed in recent years - so this is not a driving force in the relatively high vacancy rates. However, the relatively high levels of assisted housing units constructed in the early 1990s in Ontario did play a role, as this source offered competition to the private sector. As well, overbuilding of private rental units in the latter 1980s in some centres (such as Montreal and Winnipeg) is still having a lingering impact.

Demand side factors have also played a role.

The sharp increase in the overall vacancy rate in the early 1990s reflected the weak economic conditions in most major markets at that time, as well as less favourable demographics (with fewer households in the prime first-time renter age groups; refer back to Figure 5).

In addition, favourable affordability of homeownership (Figure 34), due to historically low mortgage interest rates, and house price declines in the early 1990s, have increased the relative attractiveness of owning vs. renting - and lured many first-time buyers away from the rental market.

**Figure 34**




* Mortgage payments on average-priced home sold through MLS as % of average family income
Source: Clayton Research based on data from The Canadian Real Estate Association, Statistics Canada and The Bank of Canada

### Recent Trends in Selected Major Markets

This section focuses more closely on recent rental market conditions in Halifax, Montreal, Toronto, Winnipeg, Calgary and Vancouver.

#### *Halifax*

The overall vacancy rate for private rental apartments in Halifax came down considerably in 1998 (Figure 35). At 5.5%, however, the rate remains excessive.

As discussed in Chapter 2, Halifax is one of the few markets in Canada with any significant degree of new rental unit construction in the 1990s. This has contributed to high vacancy rates - and taken its toll on rent levels. The recent decline in the vacancy rate, however, has put an end to the declining real rents (nominal rents adjusted for inflation)[6] that have characterized the 1990s. Vacancy rates will need to come down more substantially, however, before significant rent increases are achievable.

#### *Montreal*

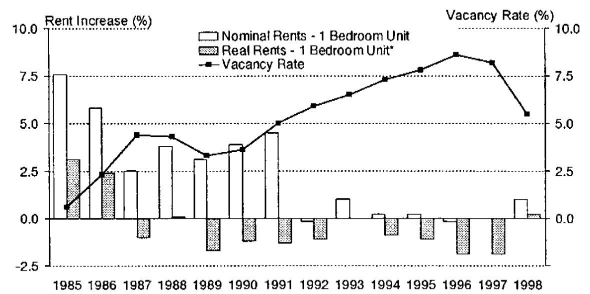
Vacancy rates in Montreal increased steadily from the mid 1980s to the early 1990s (Figure 36) - a result of increases in the supply of new units (as investors responded to rising real rents in the latter 1980s), as well as weaker demand.

The excess is being worked down, but despite only minimal new construction in recent years (as shown in Chapter 2) it has been a slow process.

[6] Rents are CMHC data for average rents for all 1 bedroom units covered by the survey and do not reflect quality changes. If a substantial amount of new building was occurring, this could lead to some overstatement in terms of rent increases on individual units; however, the limited amount of new, higher-rent, units being added to the stock in the 1990s relative to the latter 1980s (refer back to Figures 10 through 15) suggests that this would have been more of an issue in the latter 1980s than currently.

## Figure 35

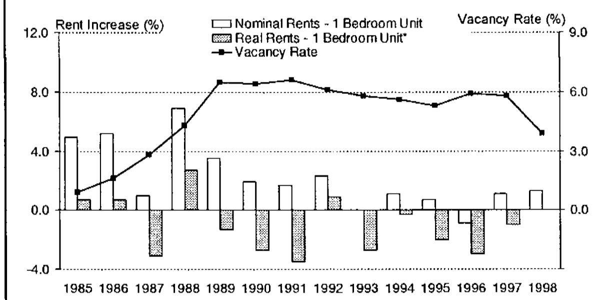
**Vacancy Rates and Rent Increases
Halifax, 1985-1998**




* Nominal rent increase less inflation
Source: Clayton Research based on CMHC data

## Figure 38

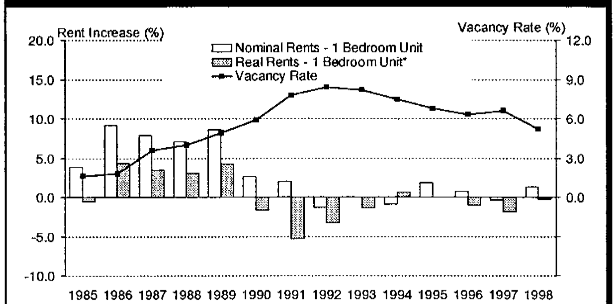
**Vacancy Rates and Rent Increases
Winnipeg, 1985-1998**




* Nominal rent increase less inflation
Source: Clayton Research based on CMHC data

## Figure 36

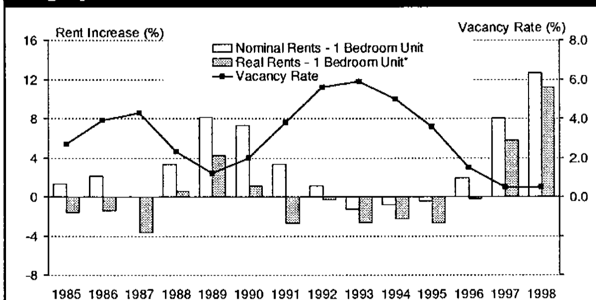
**Vacancy Rates and Rent Increases
Montreal, 1985-1998**




* Nominal rent increase less inflation
Source: Clayton Research based on CMHC data

## Figure 39

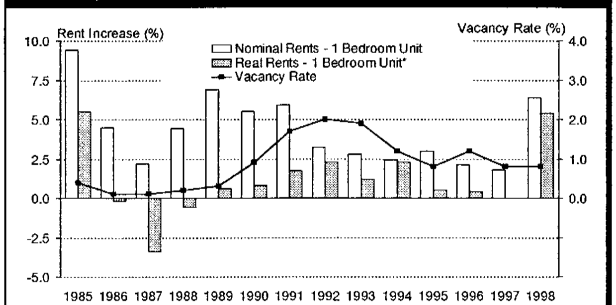
**Vacancy Rates and Rent Increases
Calgary, 1985-1998**




* Nominal rent increase less inflation
Source: Clayton Research based on CMHC data

## Figure 37

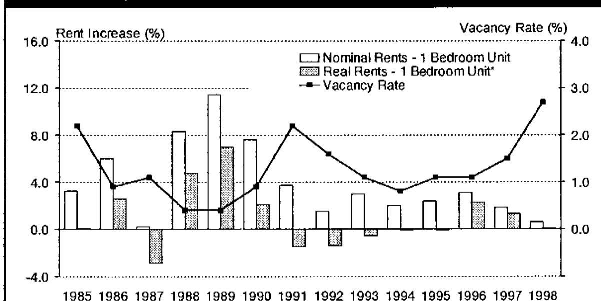
**Vacancy Rates and Rent Increases
Toronto, 1985-1998**




* Nominal rent increase less inflation
Source: Clayton Research based on CMHC data

## Figure 40

**Vacancy Rates and Rent Increases
Vancouver, 1985-1998**




* Nominal rent increase less inflation
Source: Clayton Research based on CMHC data

*Toronto*

Although the vacancy rate in Toronto increased in the early 1990s, it has remained relatively low compared to most major markets, and well below the 3 percent threshold (Figure 37). As a result, Toronto is the only centre examined here where real rents continued to increase in the 1990s - until recently, however, the gains were modest.

The declines in the vacancy rate that have occurred in more recent years, the lack of new rental construction (either private or assisted) as well as the recent changes in rent control legislation in Ontario (as discussed later in this chapter), are all favourable for increased rent levels over the next few years - as evidenced by the stronger rent increases exhibited in 1998. Recognition of these factors has contributed to the increased interest among investors in purchasing existing rental units (refer back to Figure 21), as well as prompted more investors to consider the possibility of new development.

*Winnipeg*

The relatively high levels of new construction in the latter 1980s, combined with relatively weaker demand in the 1990s, have kept vacancy rates in Winnipeg elevated since the latter 1980s (Figure 38). However, vacancy rates are declining, and rent increases once again are starting to keep up with inflation.

*Calgary*

The Calgary rental market has been among the most volatile over the past 10 years. After declining in the latter 1980s (Figure 39), vacancy rates shot up again in the early 1990s - and rents fell through the mid 1990s.

There has been a dramatic turnaround in the Calgary rental market, however, in recent years, with the vacancy rate falling from over 6 percent in 1993, to less than 1 percent in 1997 and 1998. The very tight supply situation (due to the combined impact of little new construction and conversions of large numbers of rental units to ownership) has had the effect that one would expect in a market without rent controls - rents are on the rise.

*Vancouver*

Relatively buoyant demand levels in the 1990s led to lower vacancy rates, which helped landlords in general to achieve rent increases above inflation in the past few years.

However, with the emergence of weaker economic conditions, the vacancy rates have been increasing and increases in real rents have virtually come to a halt.

## External Factors Impacting the Rental Investment Decision

This section discusses some of the key "external" factors which can have a direct impact on the rental investment decision but which are not generally within the control of the investor.

### Federal Government Programs to Encourage New Rental Supply

*Private Sector*

There are currently no federal government initiatives in place to encourage new private rental supply.

In past years, however, several federal programs provided private rental investors with various incentives to develop new rental housing (Figure 41). These included:

- Loans to limited dividend companies (LD);
- The Assisted Rental Program (ARP); and
- The Canada Rental Supply Plan (CRSP).

Over 200,000 private sector rental units were built under these three programs.

**Figure 41**

| Federal Government Programs to Assist Private Rental Construction | |
|---|---|
| **Current Situation** | No current federal programs in place to assist new private rental construction |
| **Past Incentive Programs** | **Canada Rental Supply Plan (CRSP)**<br>• late 1981 to 1984<br>• interest-free loans to private rental developers; no payment due for 15 years<br>• About 25,000 units were developed under the program<br>**Assisted Rental Program (ARP)**<br>• 1974-1978<br>• Initially grants (and later, interest-free loans) to developers of private rental units<br>• Could be combined with MURB provisions<br>• About 123,000 units were subsidized under the program<br>**Loans to Limited Dividend Companies (LD)**<br>• 1946-1975 (major thrust 1969-1975)<br>• Long-term, low interest loans provided to developers of private rental rental units; in return, owners limited rents on the projects<br>• About 63,000 units were subsidized under the program |
| Source: Clayton Research based on information in **Rental Housing: A Study of Selected Local Markets**, prepared by Clayton Research Associates Limited, Jules Hurtubise and CitySpaces Consultants for CMHC and British Columbia Housing Management Commission, 1991 | |

### *Social Housing*

In addition to these programs aimed at subsidizing the private sector, the federal government has historically played a strong role in the provision of assisted/social housing, through its public and non-profit housing programs (Figure 42).

In 1994, however, as part of its deficit reduction efforts, the federal government stopped funding new coop and non-profit housing.

At present, the federal government is negotiating the transfer of social housing responsibilities to the provinces. It is also exploring the potential role of public-private partnerships.[7]

While assisted housing programs do not have a direct impact on investors in private rental housing, they are a very important factor to consider in the investment decision. This is because assisted housing does compete with the private sector - the most recent evidence of this is in Ontario in the 1990s.

[7] The following definition of "public-private partnerships" has been adopted by The Canadian Council for Public-Private Partnerships: "A cooperative venture between the public and private sectors, built on expertise of each partner, that best meets clearly defined public needs through the appropriate allocation of risks, rewards, and responsibilities."

**Figure 42**

| Federal Government Programs for Assisted/Social Housing | |
|---|---|
| **Current Situation** | Not currently active in providing new assisted/social housing<br>Negotiations underway to transfer social housing to the provinces<br>Exploring potential private-public partnerships |
| **Past Programs** | **Non-Profit and Coop**<br>• from 1973 to 1994<br>• terms varied from low-interest loans, to interest subsidies to 100 percent insured loans plus grants to offset operating losses<br><br>**Public Housing**<br>• 1949-1985 (peaked in the early 1970s)<br>• under various federal/provincial arrangements, each level of government shared capital costs and operating costs for projects aimed at the needy |
| Source: Clayton Research based on information in **Rental Housing: A Study of Selected Local** Markets, prepared by Clayton Research Associates Limited, Jules Hurtubise and CitySpaces Consultants for CMHC and British Columbia Housing Management Commission, 1991 | |

## Financing Private Rental Investment

This section examines current lending practices for private rental investment.

Most private rental investment - be it new development, or purchase of private rental projects, or in many cases capital improvements - (i.e. renovation work) entails some form of financing, generally in the form of a mortgage. The key exception is investment by pension funds, who typically purchase rental properties on a cash deal basis.

The current lender practices related to financing rental investment are outlined on Figure 43; key recent changes are also noted. Information specific to the role of CMHC insurance is outlined on Figure 44.

### *Current Practices*

Key aspects of the current lending practices for rental investment include:

- **Value for lending purposes:** this is determined by applying a capitalization rate to the net operating income (total revenues less operating costs); for new development in particular, the lending value may fall far short of the project development costs;
- **Loan-to-value ratio (LTV)**: lenders will typically finance up to 85 percent of the lending value for a CMHC insured mortgage and 75% for an uninsured (i.e. conventional) mortgage;
- **Debt coverage ratio (DCR):** typically the DCR - the net operating income compared to mortgage payments - is at least 1.1. Lenders may be flexible, if the borrower provides some additional security or personal guarantees.
- **Mortgage rate**: Lenders generally set the mortgage rates for rental investment based on a premium above the Government of Canada bond rate for a comparable term - the "typical" spread is 50 to 75 basis points above the bond rate for CMHC insured mortgages and 100 to 150 basis points if not CMHC insured. However, rates are negotiable between lender and borrower, and depending on circumstances, could be more or less favourable than the typical rates.

CMHC also has specific practices related to insured mortgages.

**Figure 43**

| **Financing Private Rental Investment** | |
|---|---|
| **Current Situation** | **General**<br>• Financing generally obtained for new construction and purchase of existing buildings<br>• Traditional sources are banks, trust companies, life insurance companies; alternate sources include "near banks"<br>• High-ratio mortgages (loan-to-value >75%) require mortgage loan insurance; in some case where LTV is 75% or less, lender may still require insurance as a condition of obtaining the financing |
| | **Pricing Policies:**<br>• Interest rate for a given term generally set in relation to the comparable Government of Canada bond rate (therefore moves with general rate changes)<br>• For CMHC insured mortgages, typical spread is 50-75 basis points; for non-insured, spreads can be 50 to 75 basis points higher than for CMHC insured (i.e. 100 to 150 basis points, or more, above bond yield)<br>• Posted rates are negotiable between the lender and the borrower; at present excess supply of capital has been favourable for lower rates |
| | **Typical Lender Criteria/Policies**<br>• A value for lending purposes determined based on applying a capitalization rate to net operating income (total revenues less operating costs); for new development in particular, the lending value may fall far short of the project development costs<br>• Lenders typically will finance a maximum of 85% of the lending value for an insured mortgage and 75% for an uninsured (i.e. conventional) mortgage<br>• Debt coverage ratios (DCR) - the net operating income must be at least equal to 1.1 times the mortgage payments. Lender may be flexible, if the borrower provides some additional security or personal guarantees. |
| **Key Historical Changes** | **Positive cash flow**<br>• After the losses of the early 1980s, lenders are reluctant to lend on rental projects with negative cash flow; this practice was prevalent in the 1970s, when tax incentives could offset some of the impact<br>**Maximum loan**<br>• Again, after the losses suffered by CMHC in the early 1980s, it decreased the maximum amount on insured loans to 85% from 90% |
| Source: Clayton Research based on information compiled from discussions with CMHC, lenders and investors for this study | |

**Figure 44**

## CMHC Mortgage Insurance for Rental Properties

**Current Situation** (policies in effect when study was conducted)

**General:**

- Both for financing new construction and purchase of existing buildings
- Required where equity is less than 25% of project value
- Optional where equity is at least 25% of project value; however a lower interest rate can generally be obtained if CMHC insured
- Interest rates for CMHC insured loans typically 50-75 basis points above bond rate for comparable term (at least 50 basis points below rate for conventional, which are typically 100-150 above bond rate)

**Basic Premium Rates:**

| Loan-to-Value Ratio: | New Construction* | Existing |
|---|---|---|
| Up to 75% | 2.0% | 1.5% |
| 76%-80% | 2.5% | 2.0% |
| 81%-85% | 5.0% | 3.0% |

** A premium of 0.5% is incurred if mortgage is advanced in stages during the construction period*

**Standard Underwriting Criteria:**

- Debt-coverage ratio (DCR): Net operating income (NOI) must be at least 1.1 times mortgage payment based on a 9% mortgage interest rate and 25 year amortization period
- For projects of more than 6 units, value for lending purposes established based on minimum cap rate of 9%
- Personal guarantees/covenants may be required

**Changes Effective Jan. 1/99**

Changes apply to existing rental properties only; policies related to new units currently under review

**Changes to Basic Premium Rates:**

| Loan-to-Value Ratio: | Current | Effective Jan. 1/99 |
|---|---|---|
| Up to 65% | 1.50% | 1.75% |
| 66%-70% | 1.50% | 2.00% |
| 71%-75% | 1.50% | 2.25% |
| 76%-80% | 2.00% | 3.50% |
| 81%-85% | 3.00% | 4.50% |

**Key Changes to Standard Underwriting Criteria:**

- DCR increased to 1.3 for mortgage terms of less than 10 years and 1.2 for mortgage terms of 10 years or more for projects of more than 6 units; the mortgage rate of the application to be used to determine the DCR, not a minimum 9% rate
- Lending value to be determined using "market derived capitalization rates", rather than the previous 9% minimum
- Additional guarantees limited to a maximum of 50% of the loan amount for 85% LTV; reduction of 2% points for each percentage point reduction in the LTV

Source: Clayton Research based on information obtained from CMHC and structured interviews with lenders

CMHC recently announced changes to its mortgage insurance policies for existing buildings effective January 1, 1999; policies for new rental housing are still under review. Current CMHC practices and planned changes are outlined on Figure 44. Highlights include:

- **Requirement for insurance**: mortgage insurance is required when the equity in the project is less than 25 percent of the value. While "optional" where equity is 25 percent or more, investors will sometimes opt for insurance in order to obtain a lower interest rate - as indicated above, interest rates for insured mortgages are typically 50 basis points below rates for conventional mortgages; as well, in some cases lenders may require that the borrower take out mortgage insurance as a condition of obtaining the financing, even if the downpayment ratio is 25% or more.
- **Insurance premiums**: premiums vary depending on the loan-to-value ratio, and whether for new construction or existing (see Figure 44); new premiums for existing units are scheduled to be introduced January 1, 1999. Typically the premium is added to the amount of the mortgage.
- **Debt-coverage ratio (DCR):** at present, a DCR of 1.1 is used, based on a 9% mortgage rate; for existing properties, this is scheduled to change effective January 1, 1999 (to 1.3 for mortgage terms of less than 10 years and 1.2 for terms of 10 years or more), but will then be calculated using the actual mortgage rate in the application, which typically will be well below the previously used 9%.
- **Value for lending purposes:** at present, this is determined by applying a minimum 9 percent capitalization rate to the net operating income (total revenues less operating costs); for new development in particular, the lending value may fall far short of the project development costs. Effective January 1, 1999 CMHC will adopt market derived capitalization rates for existing rental properties.

*Recent Changes in Lending/Insuring Practices*

There have been several changes related to financing private rental investment since the early 1980s that have either enhanced or detracted from the attractiveness of investment in private rental housing.

On the positive side, the key change is the low interest rate environment that currently prevails. As indicated earlier, lenders generally set mortgage interest rates for rental investment in relation to the comparable term bond rates. Therefore, the lower interest rate environment - and specifically lower bond rates (Figure 45) - in recent years has been a positive factor for rental investment.

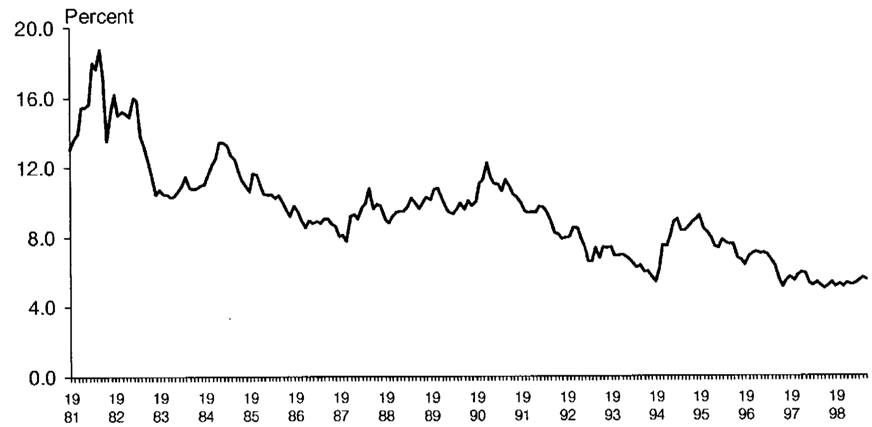
In addition, competition among lenders in general and the desire among some to rebuild the share of rental properties in their loan portfolios after pulling back in the 1980s, have also opened up opportunities for even more favourable interest rates. Lower mortgage rates in general have reduced the costs of financing - and, consequently, been a boost to cash flow.

On the negative side, however, several key changes to lending/insuring policies since the early 1980s (when lenders and insurers suffered heavy losses on real estate) have detracted from the attractiveness of rental investment:

- The reduction in maximum loan values for insured mortgages from 90% to 85%;
- The unwillingness of lenders to lend on negative cash flow; and
- Increases in CMHC mortgage insurance premiums and stricter underwriting criteria (although some of the new changes introduced for existing properties will help, such as the move to a market interest rate).

**Figure 45**

**5 Year Government of Canada Bond Rate 1981-1998**




Source: Clayton Research based on Bank of Canada data

In general, these changes have increased the relative amount of equity that investors must put into a project - and reduced the potential for leverage.

### Rent Controls/Review and Landlord/Tenant Legislation

#### *Rent Controls/Review*

Rent control is a fact of life for investors in rental housing in Canada. As rent controls are under provincial jurisdiction, they vary substantially by province. A summary of current provincial rent control schemes is provided in Figure 46.

Only 4 out of 10 provinces do not have any form of rent control or review system currently in place (the last year that each had a form of rent control/review is shown in parentheses):

- Nova Scotia (1993)
- New Brunswick (1985)
- Saskatchewan (1993)
- Alberta (1980)

**Quebec** has a form of rent review, but it is relatively liberal. Landlords and tenants are encouraged to negotiate rent increases; tenants can dispute proposed increases, but this is relatively uncommon.

In **P.E.I.** and **Manitoba,** the province sets a maximum rent increase each year.

Until recently, this was also the case in **Ontario.** However, the new **Tenant Protection Act,** which took effect in June 1998, now allows for rents to be set at market rents when a unit is vacated. A maximum annual rent increase set by the Province (3% for 1998) will still apply to units which have not been vacated. Any new units built will be exempt from maximum annual increases indefinitely.

Rent controls began to be phased out in **British Columbia** beginning in 1978 and were removed entirely in 1983. However, a form of rent review was reintroduced in 1996. Under this system, landlords can set market rents for vacated units.

**Figure 46**

| **Summary of Rent Control /Review Schemes by Province** | |
|---|---|
| **Newfoundland** | System of rent review; changes currently being proposed |
| **P.E.I.** | Maximum rent increases set each year by Government<br>Landlords can apply for a higher increase; must prove warranted |
| **Nova Scotia** | No rent controls/review (rescinded in late 1993) |
| **New Brunswick** | No rent controls/review (rescinded in 1985) |
| **Quebec** | System of rent review<br>Publish guidelines each year, but not binding; landlords and tenants encouraged to negotiate increases; disputes may be arbitrated but rare<br>New units exempt for first 5 years |
| **Ontario** | Various systems since 1975<br>Tenant Protection Act replaced restrictive Residential Rent Control Act and several other Acts in June 1998<br>Rents can be set at market rents for vacated units; for other units, rents can be increased by a set guideline and renovation costs can be passed through to tenants; new units exempt indefinitely |
| **Manitoba** | Maximum rent increases set each year by Government<br>New rental projects exempt for 5 years |
| **Saskatchewan** | No rent controls/review (rescinded in 1993) |
| **Alberta** | No rent controls/review (rescinded in 1980) |
| **British Columbia** | Rent controls were phased out beginning 1978; were completely removed by 1983<br>"Rent protection" system reintroduced in 1996<br>Rents can be set at market rents for vacated units<br>For other units, landlord can select an annual rent increase; if appealed by tenant, must be able to be supported by increases in costs |

Source: Clayton Research based on information compiled from the Provinces

For other units, landlords can propose a certain increase; if the tenant disputes it, the landlord must show that it is justified by increased costs.

An important aspect of rent controls in terms of their impact on the rental investment decision is the fact that they are subject to change, depending on the goals and political agenda of the provincial government in power at any particular point in time. This situation is best exemplified by the case of Ontario, where various systems of rent control have been in effect since 1975, and to a lesser extent, B.C. where controls were removed completely, only to be reintroduced in a milder form at a later date.

Constant policy changes complicate the investment decision, as investors do not necessarily know when, and to what degree, the "rules may change" after the decision to invest has already been taken.

***Landlord Tenant Legislation***

In addition to restrictions on annual rent increases, many provinces have landlord tenant legislation which encompass the rights and responsibilities of tenants and landlords. These can vary substantially from province to province and are not therefore dealt with in detail here.

However, as evidenced in the interviews with rental investors conducted for this study, there in general is a feeling among landlords that this legislation favours tenants over landlords. While no doubt tenants have a different perspective, the landlords' perceptions are important in terms of this study to the extent that they detract from the perceived relative attractiveness of investment in private rental housing.

### Income Tax Policies

This section reviews federal government tax policies as they relate to investment in rental housing.[8] The current situation, and key past changes, are summarized on Figure 47.

***Capital Cost Allowance (CCA)***

CCA deductions allow the treatment of depreciation on a building as an expense for income tax purposes - and in most cases at a rate in excess of actual depreciation. The CCA claimed on the building is subject to recapture as income when the building is sold, if the sale price exceeds the depreciated value of the building. The use of CCA is attractive in that it can be viewed as an interest free loan until it is recaptured upon the sale of the building.

Currently, only companies in the business of real estate can deduct CCA losses against other income; it cannot be used by individuals and non real estate companies. Prior to tax reform in 1972, however, all investors in rental housing (and other types of real estate) could deduct CCA from income from other sources. Now, individuals investing in rental properties are limited to using CCA to offset income from the property itself - not other income sources. This eliminated a tax shelter often used by high-income individuals.

Tax reform in 1972 also eliminated the ability to pool rental properties to avoid recapture of CCA at the sale of a building. This applied to both companies in the business of real estate as well as other investors in rental housing.

In late 1974, the tax deductibility of CCA on new rental residential buildings from other sources of income was introduced on a temporary basis for individuals and companies not in the business of real estate. This was the **Multiple Unit Residential Building (MURB)** provision of the Income Tax Act. This resulted in a large number

[8] This section draws on an analysis conducted by Clayton Research in **Rental Housing: A Study of Selected Local Markets**, prepared for CMHC and the British Columbia Housing Management Commission.

of syndications of new rental projects to investors wishing to take advantage of the MURB tax shelter. The MURB provision was allowed to expire at the end of 1979; it was reinstated in 1980 and finally expired at the end of 1981.

Therefore, in effect, the ability to deduct CCA against income from other sources was available to all investors throughout the 1960s up to 1981, with the exception of the 1972-1974 period and part of 1981. Since 1981, this ability to deduct CCA against income from other sources has been limited to companies in the business of real estate. Other investors can only use it to offset income from the rental property itself.

Commencement of the use of CCA is restricted to the first year in which the building is "available for rent". The depreciation rate has varied over time. The current rate of depreciation is 4% per year; however, in the first year in which the asset is acquired the "half-year rule" applies (i.e. rate is 2% in the initial year, and 4% of the declining balance each year thereafter).

***Deductibility of Soft Costs***

Soft costs are expenditures incurred by the owner of a new rental property which are not related to the actual acquisition of the fixed assets (i.e. the land, building and equipment).

Allowable soft costs can be deducted from income from the project in calculating tax. At present allowable costs for all owners are landscaping, some site investigation costs and financing fees. For companies in the business of real estate, allowable costs also include promotion expenses, legal and accounting fees, mortgage fees, interest fees during construction and property taxes.

Generally, other costs are required to be capitalized into the value of the building and depreciated over time.

Currently, allowable costs can only be deducted in the period they relate to, not all upfront in the first year. Prior to 1979, soft costs could be deducted upfront in the first year, regardless of the period they related to.

In 1981, the types of soft costs allowed were restricted for those not in the business of real estate. Previously, interest and property taxes during construction, architects' fees and building permits were allowed; now these must be capitalized into the value of the building and depreciated over time.

***Treatment of Capital Gains***

In calculating income for tax purposes, 75 percent of any capital gains from the sale of rental properties are included.

Prior to tax reform in 1972, capital gains on rental properties were not taxable; following 1972, 50 percent of capital gains were included in income for tax purposes; this was increased to 66.67% in 1988 and to the current 75 percent in 1990.

In 1985 a lifetime capital gains exemption for individuals was introduced. At the time, the intent was to gradually raise the limits from an initial $20,000 to $500,000 by 1990. The level, however, was capped at $100,000 in 1987 and ultimately removed in 1994. While in effect, this exemption encouraged small investors and increased the supply of non-purpose built rental housing (such as condominium apartments being rented out by their owner).

***Treatment of Rental Losses***

As a general rule, the losses on any rental property can be deducted from income from other sources in order to calculate income for tax purposes. Such losses could result from a situation where rental revenues are insufficient to cover the out-of-pocket expenses associated with the project (that is, the operating costs and mortgage payments), but not deprecation on the building (as discussed in the CCA section). This has been an on-going tax feature.

In past years, this feature was of particular importance for new rental buildings, which often experienced negative cash flow in the early years of a project. However, as discussed in the section on financing, current lending criteria require that cash flow more than cover debt payments.

***Implications of Income Tax Changes for Rental Investment***

Many of the changes made in the treatment of rental housing for tax purposes since the early 1970s were implemented to "even out the playing field" - that is, investors in rental housing previously had benefits not shared by other investors.

Nonetheless, from an investment perspective, there is no question that the removal of these advantages have seriously reduced the attractiveness of investment in rental housing in Canada.

***U.S Income Tax Treatment More Favourable to Investors***

Differences between Canada and the U.S. in how rental investment is treated for income tax purposes have likely been a factor in the relatively more buoyant levels of new private rental unit construction that have occurred south of the border since the early 1980s (refer back to Figure 7).

In the U.S., rental investors not in the business of real estate can defer triggering taxation of recaptured depreciation (CCA) and capital gains when a property is sold by purchasing another property of equal or greater value; in Canada, the recaptured depreciation and capital gain are taxed in the year of the sale. As well, in the U.S. the taxation of recaptured depreciation is done on the same basis of capital gains taxation, with only a small portion of the gain subject to taxation (20 percent or so).

In addition, the federal government in the U.S. provides a Low-Income Tax Credit as an incentive for the private sector to produce lower-income housing. This credit offers investors a dollar-for-dollar credit against federal income taxes for investing in low-income rental housing. Developers raise equity by selling ownership interests in the properties with the purchasers of the equity being eligible for the tax credit.

### Other Forms of Taxation

This section briefly reviews other key forms of taxation and their relevance to investment in rental housing.

***Sales Taxes***

In most regions of Canada, new rental housing is subject to the federal Goods and Services Tax (GST) of 7%. In Quebec, both the GST and the Quebec Sales Tax (currently 7.5%) apply. In the Atlantic Region, the harmonized federal/provincial HST is applied at a rate of 15%. Unlike the situation for new ownership housing, no rebates are available for new rental housing of these taxes.

The introduction of the GST, and in some regions the extension of the coverage of provincial sales tax, have added to the costs of developing new rental units. Previously, only building materials were taxed under the manufacturers sales tax. In general, building products were taxed at a favourable rate. For example, in the last year of the federal sales tax, the general rate was 13.5% and the rate for building materials 9%.

As the GST/QST/HST also apply to operating costs, investors in existing rental housing have also seen their cash flow negatively impacted by their introduction.

There is no tax comparable to the GST in the U.S.

**Figure 47**

| Summary of Major Income Tax Policies Related to Rental | |
|---|---|
| **Capital Cost Allowance (CCA)** | **Current Situation:**<br>• Allows the depreciation on a rental building to be used as an expense for income tax purposes, at a rate above the actual rate of depreciation; CCA amount claimed is subject to recapture as income at sale of property<br>• Companies in the business of real estate can use the deduction to offset losses from other income; for other investors, deduction can only be used to offset the income from the property itself<br>• Commencement of deductions start in the first year building is "available for rent; rate is 2% in first year, and 4% thereafter<br>**Key Past Changes:**<br>• Prior to tax reform in 1972, individuals and companies not in the business of real estate could use the CCA deducation to offset income from other sources; MURB provision of the Income Tax Act temporarily reinstated this ability from late 1974 to end of 1979 and for part of 1980 through the end of 1981<br>• Tax reform also eliminated the ability to pool properties to avoid recapture of CCA at sale of property<br>• Rate of depreciation reduced over the years - prior to 1978, 10% for woodframe and 5% for concrete and steel reinforced; in 1978 both set at 5%; in 1987, both reduced to 4%; "half-year rule" introduced in 1981 |
| **Deductibility of Soft Costs** | **Current Situation:**<br>• Soft costs are expenditures incurred by the owner of a new rental property which are not related to the actual acquisition of the fixed assets (i.e. the land, building and equipment); allowable soft costs can be deducted from income from the project in calculating tax<br>• Allowable costs include landscaping, some site investigation costs and financing fees; for companies in the business of real estate, also includes promotion expenses, legal and accounting fees, mortgage fees, interest fees during construction and property taxes<br>• Other costs required to be capitalized into the value of the building and depreciated over time<br>• Can only be deducted in period they relate to, not all upfront in the first year<br>**Key Past Changes:**<br>• Prior to 1979, soft costs could be deducted upfront in first year, regardless of the period they related to<br>• In 1981, the types of soft costs allowed were restricted for those not in the business of real estate |
| **Treatment of Capital Gains** | **Current Situation:**<br>• 75% of capital gains from sale of rental properties are included as income for tax purposes (100% for companies in the business of real estate)<br>**Key Past Changes:**<br>• Prior to tax reform in 1972, capital gains on rental properties were not taxable; following tax reform, 50% of capital gains were included for tax purposes; this was subsequently increased to 66.67% in 1988 and the current 75% in 1990<br>• In 1985, the lifetime capital gains exemption was introduced for individuals; at the time the intent was to raise the limits from an initial \$20,000 to \$500,000 by 1990; the level however was capped at \$100,000 in 1987; the exemption was eliminated in early 1994 |
| **Treatment of Rental Losses** | **Current Situation:**<br>• Losses on any rental property can be deducted from income from other sources in order to determine income for tax purposes<br>• Such losses could result where rental income is insufficient to cover out-of-pocket expenses (i.e. operating costs and mortgage payments) - but not depreciation on the building<br>**Key Past Changes:**<br>• This has been an on-going tax feature |

Source: Clayton Research based on information in **Rental Housing: A Study of Selected Local Markets,** prepared by Clayton Research Associates Limited, Jules Hurtubise and CitySpaces Consultants for CMHC and British Columbia Housing Management Commission, 1991

*Property Taxes*

Property taxes vary by municipality and are therefore not discussed in detail here.

However, it is worth noting that, in general, they have been increasing as municipalities attempt to compensate for reduced provincial funding.

There is also the issue of the relative rate of taxation between rental properties and condominiums. In Ontario, for example, property tax rates for rental properties are typically at least twice that for condominiums.

Ontario, however, has recognized the detrimental impact this relatively higher rate of taxation has on rental investment. In early 1997, as part of the **Fair Municipal Finance Act**, any buildings registered as condominiums are to be included in the same property tax class as single-family dwellings.

As well, municipalities were given the **power** to tax existing rental properties at a rate consistent with owner-occupied condominiums or single-family homes. In addition, municipalities can now set up a separate property tax class for new rental buildings (which would apply only if the buildings were not registered as condominiums), which would allow them to be taxed below the rate for existing rental buildings for an 8 year period. However, there is no **requirement** that municipalities take either action.

### Other Government-Mandated Costs

In addition to taxation, there are other government-mandated costs that play a role in rental investment. The key ones are discussed in this section.

*Building Codes/Planning Process*

In general, trends have been towards more, rather than less, restrictive building code requirements and more onerous planning processes. These have increased the costs of development for new rental housing.

*Development Charges*

In some provinces, most notably Ontario and B.C., development cost charges/lot levies are imposed on new development. These costs vary substantially by local area, and are not dealt with in detail here; development cost charges related to rental development are provided for Toronto and Vancouver in Chapter 5.

## The Environment for Private Rental Housing Investment in the 1990s - Summary of Key Findings

- Rental vacancy rates started to rise dramatically in Canada's major markets in the latter 1980s - and have remained high in historical terms through the 1990s (although they are now on the decline). As a result, real rent increases have not been obtainable in most centres in recent years.
- Vacancy rates and rents reflect the interaction between demand and supply. While there have been relatively few new rental units constructed in recent years, the relatively high levels of assisted housing units constructed in the early 1990s in Ontario did contribute to higher private sector vacancy rates (as this source offered competition to the private sector), as did overbuilding of private rental units in the latter 1980s in some centres (such as Montreal and Winnipeg).
- Demand side factors have also played a role. The sharp increase in the overall vacancy rate in the early 1990s reflected the weak economic conditions in most major markets at that time, as well as less favourable demographics (with fewer households in the prime first-time renter age groups). In addition, favourable affordability of homeownership, due to historically low mortgage interest rates, and

# CHAPTER 4 - PROFILE OF INVESTORS IN PRIVATE RENTAL HOUSING

This chapter focuses on the development of a profile of investors in private rental housing. The profile is organized around the following topics:

- The different types of investors and their relative importance;
- The types of properties being invested in (location, structural type, age, condition, etc.);
- Factors in the decision-making process;
- Financing arrangements and attitudes; and
- Financial performance.

This section draws on information from a variety of sources, including:

- Interviews conducted with investors and lenders as part of this study;
- Custom research on small investors commissioned by CMHC on the Clayton Research/NPD Group **FIRM Residential Mortgage Survey**;
- Information on recent sales transactions compiled by Fish Marks Jenkins (and its affiliates in various major markets) and Colliers; and
- Data from CMHC's insurance underwriting data base, which covers transactions which included CMHC mortgage insurance.

## Types of Investors and Their Relative Importance

This section examines the types of groups investing in private rental housing and looks at their relative importance in terms of size and their share of ownership of the stock, as well as recent sales activity. The information discussed in this section is summarized on Figure 48.

### Types of Investors

The analysis in this chapter focuses on 5 different types of investors:[9]

- **Small investors**: defined here as households who own 1-6 private rental units;
- **Public real estate companies**: real estate corporations specializing in multi-family residential in which shares may be purchased;
- **Pension funds**: this group includes the actual pension funds themselves, as well as groups which act as pension fund advisors;
- **Real Estate Investment Trust (REITs):** are a vehicle used for collective investment in real estate. Investors buy units in a REIT. The REIT income is not subject to income tax, but the earnings must be distributed monthly to participants (where they are included with the investors' personal income for tax purposes); and
- **Other medium and large investors**: this large group includes all other types of investors, including individuals who own more than 6 units, partnerships, joint ventures, other companies/corporations, and foreign investors. Developers who have retained rental properties for their own investment portfolio are also included here, although their activities with respect to new rental development are examined separately in Chapter 5. While it would be preferable to divide this group into its components for the analysis, it is not possible due to limitations in the available information.

[9] Note that in the past, life insurance companies were a significant investor group in private rental housing, particularly in Ontario. However, the life insurance companies have retreated from this sector since the early 1990s.

## Figure 48

**Profile of Rental Investors: Types of Investors and Relative Importance**

| | Small Investors | Public Real Estate Cos. | Pension Funds | REITs | Other Medium & Large Investors |
|---|---|---|---|---|---|
| **Description** | For purposes of this study, households who own 6 rental units or less | Real estate corporation specializing in multi-family residential | Pension funds and those acting in their interests (e.g. pension fund advisors/managers who make the investments on behalf of the individual pension funds) | Vehicle used for collective investment in real estate | Defined here as owners of more than 6 units; includes developers who retain for own portfolio; ownership may be individually, or in partnerships, joint ventures, corporations, etc |
| **Relative Importance:** | | | | | |
| ***Investor Group as % of All Private Rental Investors*** | In numbers, large group - roughly 1 million households (9% of total) own 1-6 rental units | Four at present: Boardwalk, Goldlist, International Properties Group and Hardwood; Metro Capital Corporation was in process of going public, but recently put on hold | Numerous; most active in rental properties are GWL Real Estate Advisors | Two currently specialize in rental properties: CAPREIT & RESREIT; several others have small share of investments in rental | Unknown in terms of exact numbers, but significant |
| ***Proportion of Stock Owned by Investor Group*** | Own an average of 1.7 units, for a total of about 1.6 million units, or roughly 1/2 of the private rental stock | About 1% | Less than 1% | Less than 1% | About 1/2 |
| ***Strength of Recent Activity*** | Unknown | Been growing and increasing market share | Only started investing in rental in past 5 years; growing steadily | Been growing and increasing market share | Varies |
| ***Importance of Rental Investment in Investor Group's Total Investment Portfolio*** | Specifics unknown, but 2/3 also own at least their own home | 100% for Boardwalk and Hardwood; Goldlist also condo development and commercial; International Properties sells converted condos; Metro Capital Corp also invests in retirement homes | Most under 10%; maximum 25%; full range of other real estate (office, industrial retail, hotel, etc.) | CAPREIT and RESREIT 100% residential rental; others generally less than 10% | Varies; average among those interviewd 80% residential rental; range of other real estate |
| ***Plans to Expand Rental Investment*** | Unknown | Yes | Yes | Yes | Mixed plans among those interviewed |

Source: Clayton Research and Fish Marks Jenkins based on information from a variety of sources (see text)

## Relative Importance of Each Investor Group in Private Rental Investment

### *Small Investors*

In terms of numbers, small investors are the largest group of investors in private rental housing. Estimates derived from custom research commissioned by CMHC on the **FIRM Residential Mortgage Survey** (Figure 49) indicate that roughly 9 percent of all households own between 1 and 6 private rental units (the majority only 1 unit). This is just under 1 million households. A relatively larger proportion of households in B.C. and Quebec own rental units (Figure 50).

Small investors are important in terms of their ownership of the private rental stock. According to the FIRM survey results, small investors own on average 1.7 rental units. This means that this group collectively owns about 1.6 million units - or roughly one-half of the estimated 3.3 million occupied private rental housing units in Canada.

### *Public Real Estate Companies*

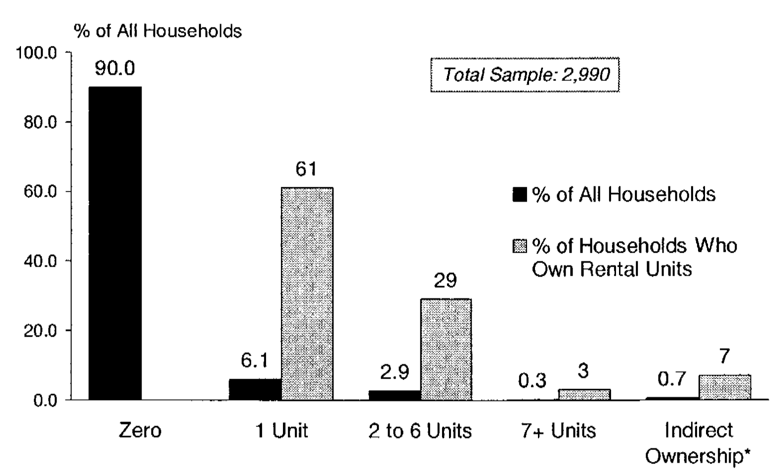
There are currently four public real estate companies specializing in multi-family investment - Boardwalk Equities, Goldlist Properties, International Properties Group and Hardwood. All began as private companies; Boardwalk went public in 1994, Goldlist and International Properties Group in 1997, and Hardwood in 1998. A fifth company, Metro Capital Corporation, had begun the process of going public in early 1998, but recently pulled its offering, at least for the time being.

Together, the public real estate companies own roughly 30,000 rental units - or about 1 percent of the private rental stock.

Boardwalk Equities has been very active in growing its portfolio since going public, doubling its size over the past year. In Alberta, where most of Boardwalk's properties are located, it accounted for over half of rental building sales in 1997.

**Figure 49**

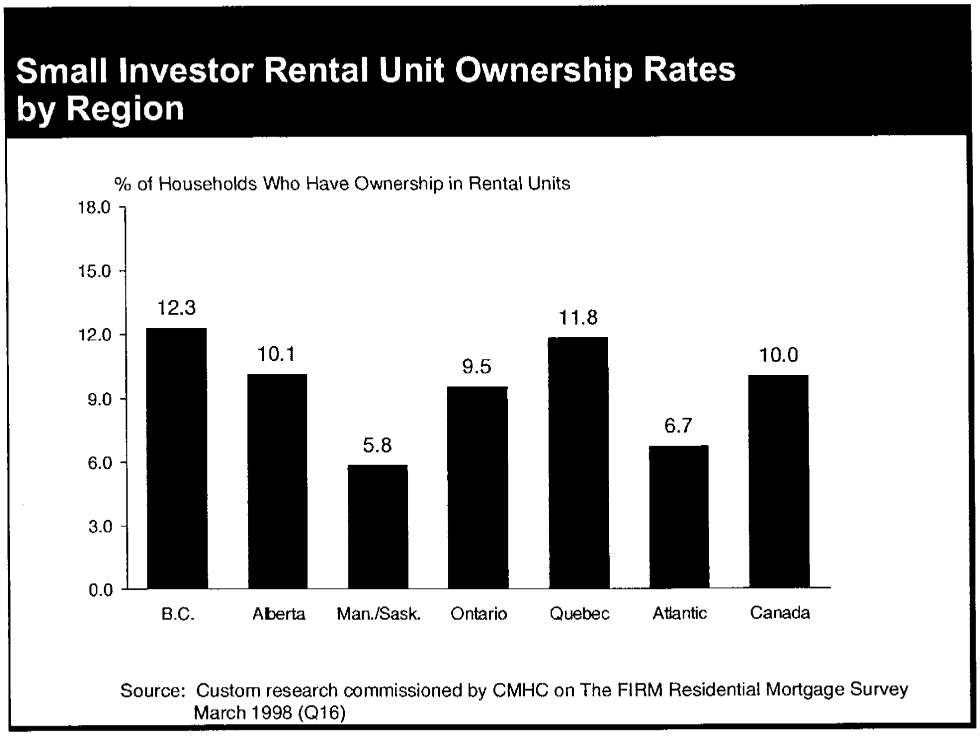
Households by Number of Rental Units Owned




* Do not directly own individual units but have indirect ownership (e.g. through syndication, REITs, etc.)

Source: Custom research commissioned by CMHC on The FIRM Residential Mortgage Survey March 1998 (Q16)

**Figure 50**




***Pension Funds***

The pension funds have only begun to get involved in real estate in general, and rental apartment investment specifically, in the past several years. To date, they have been more active in other types of real estate than rental housing.

Currently, pension funds own less than 1% of the private rental stock. However, they have played a more important role in terms of recent transactions. Data for Toronto on rental property sales involving 40 or more units show that pension funds accounted for about 12 percent of purchases in 1997 in that major market (Figure 51).

***REITs***

There are currently two REITs which specialize in rental properties - CAPREIT and RESREIT. Both were created in 1997. Some other REITs also have purchased rental properties for their portfolios, but in general rental properties comprise a very small proportion of their real estate portfolios.

Currently REITs own less than 1% of the private rental stock in Canada, but they are growing quickly. Again, data for Toronto show that REITs accounted for about 12 percent of larger sales transactions in 1997 (Figure 51) - and, given the above average size of their transactions, an even larger 26 percent of units purchased (Figure 52).

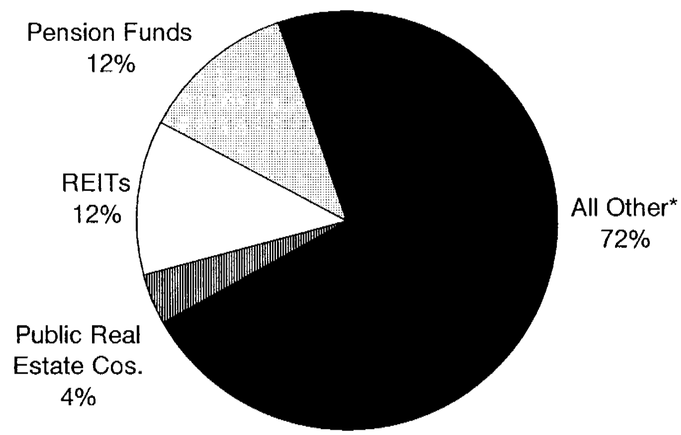
***Other Investors***

While their exact numbers are unknown, next to small investors, this is the largest investor group in terms of numbers. They are comparable to small investors in terms of their relative importance in ownership of the rental stock - at roughly one-half. Detailed information on the composition of this group is not available.

Despite the increased presence of the REITs, pension funds and public real estate companies in recent years, this investor group still accounted for the majority of larger sales transactions in Toronto in 1997 (Figure 51 and Figure 52).

**Figure 51**

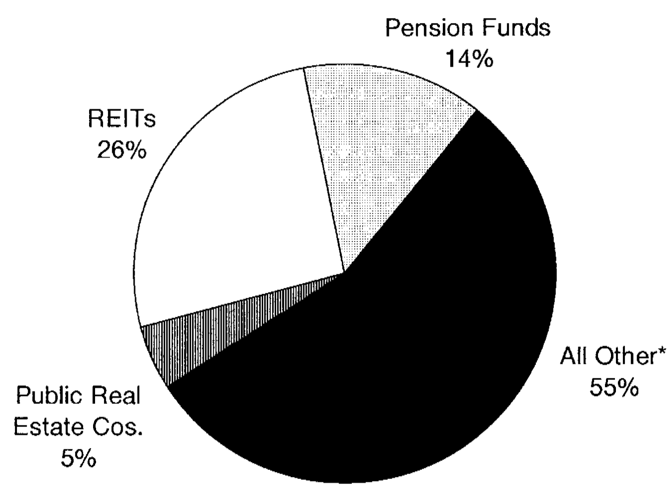
**Rental Building Purchases by Type of Investor**
**Toronto, 1997, Percent of Transactions**




* Includes a very small proportion of foreign investors (less than 5%)
Source: Clayton Research based on Fish Marks Jenkins data

**Figure 52**

**Rental Building Purchases by Type of Investor**
**Toronto, 1997, Percent of Units**




* Includes a very small proportion of foreign investors (less than 5%)
Source: Clayton Research based on Fish Marks Jenkins data

### *Broad Ownership of the Private Rental Stock Similar to the Situation in the U.S.*

Although they have increased their presence and activity in recent years, at present public real estate companies, REITs and pension funds own only a small proportion of the private rental stock in Canada - combined, less than 5%.

The ownership of the remaining stock is split roughly equally between small investors (individuals owning less than 7 units) and other investors (including individuals owning more than 6 units, partnerships, joint ventures, other companies and corporations and foreign investors).

This profile of owners of the private rental stock is broadly similar to that in the U.S. **The 1991 Residential Finance Survey** found that about 60 percent of private rental units were owned by individuals (Figure 53). While this is slightly above the estimate of about half for Canada, the Canada estimate only includes small investors i.e. individuals who own less than 7 units.

As in Canada, real estate companies and REITs play a relatively small role in private rental investment in the U.S. Separate data are not available for pensions funds.

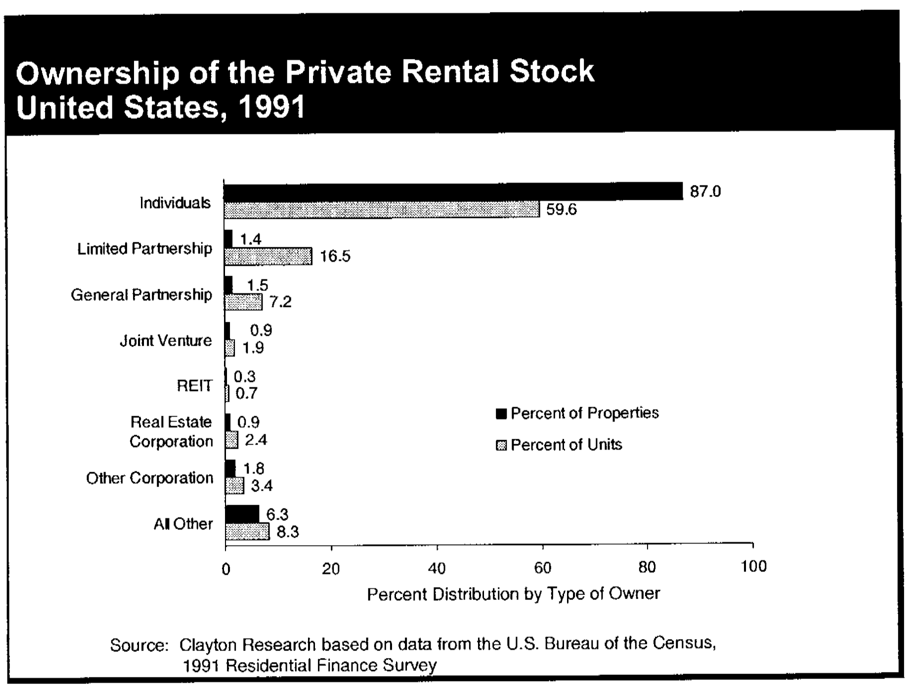
### Relative Importance of Private Rental Investment to Each Investor Group

The previous section examined the importance of each investor group to rental investment. This section examines the relative importance of rental investment to the investor group's total investment portfolio, to the extent such information is available. It also examines what other types of real estate the investor group is generally involved in, as well as plans for future expansion of its private rental investment. The results of this section are also summarized on Figure 48.

#### *Small Investors*

Data is not available to gauge how important rental investment is in a small investor's total investment portfolio. Over two-thirds, however, own at least one other property - their principal residence.

**Figure 53**




Source: Clayton Research based on data from the U.S. Bureau of the Census, 1991 Residential Finance Survey

*Public Real Estate Companies*

Boardwalk Equities and Hardwood are involved 100% in private rental investment. In addition to its rental portfolio, International Properties Group also converts and sells individually titled condominium units to individual investors and owner occupants. Goldlist Corporation and Metro Capital Corporation derive most of their income from rental investment, but also have other interests, including condominium development and retirement homes.

This group has been increasing, and plans to continue to increase, its investment in private rental housing. This will be mainly through the acquisition of existing buildings, although some consideration is also being given to developing new units for their own portfolios.

*Pension Funds*

In general, investment in rental properties accounts for only a very small proportion of the pension funds' total investment portfolios. With respect to real estate specifically, other types of real estate have played a more important role - in particular office, industrial and retail buildings.

All of the pension funds/advisors interviewed for this study indicated that they plan to expand their investment in rental properties.

*REITs*

For the two REITs specializing in rental properties (CAPREIT and RESREIT), rental investment accounts for 100% of their investment portfolio. For the other REITs, rental investment appears to generally account for only a minor proportion (well below 10%, if any).

All of the REITs interviewed for this study indicated that they plan to increase their investment in rental housing by purchasing more existing buildings. Some are also considering acquiring or developing new buildings.

*Other Investors*

Because of the diversity of this group, it is not possible to discuss the typical investor in terms of the importance of rental investment.

However, among those interviewed for this study, about 40 percent derived 100% of their revenues from rental apartment investment; the average proportion of revenues derived from rental investment was 80%. Other sources of real estate revenues included mainly office and retail properties.

About 60% of those interviewed for this study plan to increase their rental investment. This is expected to be primarily through the acquisition of more properties. However, a substantial 25% are considering developing new rental units.

## Types of Properties Invested In

This section briefly reviews the types of properties being invested in by different types of investors in terms of such factors as location, size, structural type, age, condition and target markets. The results are summarized on Figure 54.

### Small Investors

Because the rental stock itself is spread through the country, and local small investors own roughly half of this stock, small rental investors have interests throughout the country - but mainly limited to the market in which they live.

About half of the units owned by small investors are in plexes or low-rise apartment buildings (Figure 55). About one-quarter of units owned by small investors are in single-family homes, separate from their principal residence, which they are either renting out to one household, or which they have divided into 2 or more suites. Basement/accessory suites in their own homes are also common.

**Figure 54**

**Profile of Rental Investors: Property Characteristics**

| | Small Investors | Public Real Estate Cos. | Pension Funds | REITs | Other Medium & Large Investors |
|---|---|---|---|---|---|
| **Local Markets** | All | Primarily Calgary, Edmonton and Toronto; also some other Southern Ontario, Regina, Saskatoon | Mainly Toronto | Primarily the large markets: Toronto, Calgary, Edmonton, Vancouver, Montreal, Halifax | All |
| **Structural Types of Units** | About 1/2 of units owned are in plexes and other low-rise buildings See Figure 55 | Varies by company; roughly half of total units are high-rise apartment, half are low-rise and townhouse | Almost all high-rise apartment | Almost all high-rise apartment | Varies |
| **Size of Building/ Project** | Typically small | Typically 100 units or more | Typically 200 units or more | Typically 200 units or more | Varies; typically midsized (less than 100 units) |
| **Age of Structure** | Not available | Varies by company; more tend to be at least 20 years old | Typically at least 20 years (but prefer newer) | Typically at least 20 years | Typically at least 20 years |
| **Condition of Buildings** | Not available | Varies by company; generally "good" to "excellent" | Varies; generally "good" to "very good" | Varies; generally "good" to "excellent" | Varies widely - from "poor" to "excellent"; typically "good" |
| **Preferred Target Markets** | Not available | Varies by company but generally prefer moderate to higher income | Varies; some indicate no preferences; others prefer moderate to higher income small families or seniors | Middle to upper income | Varies; majority do not have specific preferences |

Source: Clayton Research and Fish Marks Jenkins based on information obtained from structured interviews and other sources

### Public Real Estate Companies

The public real estate companies primarily have invested in the major markets, in particular, Edmonton, Calgary and Toronto.

The types of properties invested in by public real estate companies vary by company. In general, however, they are larger sized projects (100 or more units), in either high-rise or low-rise apartments, at least 20 years old and in "good" to "excellent" condition.

Target markets vary by company, but in general the preference is for moderate to higher income tenants.

### Pension Funds

The pension funds have been active primarily in the Toronto market.

They have typically purchased very large (200 or more unit) high-rise apartment buildings. While the purchases have been mainly buildings 20 or more years old, the preference would be for newer buildings - limited supply, however, reduces the options. In general, the condition of the buildings is "good" to "very good".

Target markets vary. Some indicated no preferences; others indicated a preference for moderate to higher income smaller families and seniors.

### REITs

The REITs have been primarily active in the major markets, in particular Toronto, Calgary, Edmonton, Vancouver, Montreal and Halifax.

Like the pension funds, the REITs have typically purchased very large (200 or more unit) high-rise apartment buildings, 20 or more years old. In general, the condition of the buildings is considered to be "good" to "excellent". The preferred target market is generally middle to upper income.

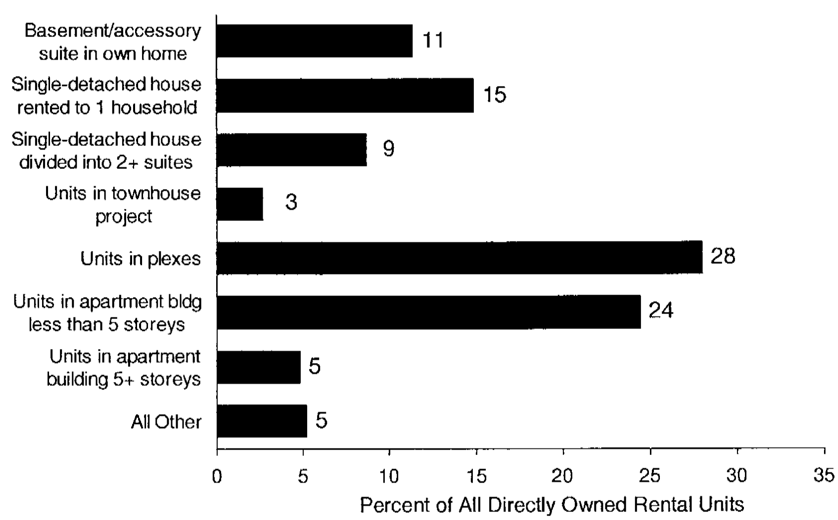
### Other Medium and Large Investors

Like small investors, the fact that this group owns roughly half of the private rental stock means in and of itself that ownership is in markets throughout the country. However, except for a few very large companies (for example, Minto), an investor typically operates in only one local market.

Given the size of this group, both building attributes and target markets can vary substantially.

**Figure 55**

**Distribution of Rental Units by Structural Type**
**Small Investors**




Source: Custom research commissioned by CMHC on The FIRM Residential Mortgage Survey March 1998 (Q16)

## Factors in the Decision-Making Process

This section explores various factors in the decision-making process. The analysis is summarized on Figure 56.

### Holding Period for Investment

In general, most investors in private rental housing are in it for the longer-term - that is, at least 10 years (Figure 57). The key exception is the pension funds, which tend to take a medium-term (5 to 10 year) view for their investments.

Some smaller investors may get into the market for "speculative" purposes - that is, hoping to make a short-term capital gain on the property. An example of this was seen in the market for condominium apartments in Toronto in the latter 1980s. When prices were increasing even before product was built, some investors purchased in hopes of "flipping" the units for a profit. However, when the market collapsed, and values tumbled, they were left with the option of renting out the units, and hoping values increased again, or selling at a substantial loss. In this way, some investment originally intended as short-term in fact became medium to longer term because of market circumstances.

This short-term timeframe for small investors, however, is the exception rather than the rule. In the survey of small investors conducted for this study, only 1 percent of respondents indicated that the main reason for their rental investment was for short-term capital gains (Figure 58).

### Key Determining Factors in the Decision to Invest

In the interviews conducted with investors for this study, the factors they take into consideration when deciding whether or not to invest in a particular project were explored. This was done in two manners. The first sought "top of mind" responses". The second asked respondents to rate the importance of a series of factors on a scale of 1 to 5, where 1 was "not important" and 5 was "very important".

#### *Top of Mind Responses*

The factor that investors most often cited as being a key determining factor in the decision-making process was location (Figure 59). Location has a range of meanings for respondents. For some, it refers specifically to particular local markets, or particular subareas of local markets (i.e. where vacancy rates tend to be lower, the potential for rent increases higher). For others, it relates more generically to favourable neighbourhood attributes (e.g. good transportation access, lower crime rates, predominantly single-family neighbourhood, etc.).

Following location, the next most common factors cited were the expected rate of return on the project, and the quality/condition of the building.

REIT respondents were the only ones not choosing location as their first answer (Table 7). For this group, the rate of return was first.

Comparable information is not available for small investors, however, the custom FIRM research undertaken for this study did explore the main reasons why small investors invest in rental housing.

Small investors have a variety of reasons for investing in rental units (Figure 58). The three most common reasons to invest are to build long term equity, to supplement income, and to help with mortgage payments. For a small proportion of this group (6%), rental investment is their primary source of income.

#### *Rating of Importance of Selected Factors*

Separate from the top of mind question, investors were also asked to rate the importance of selected specific factors in their decision whether or not to invest in a particular project.

The factor which scored the highest in importance was cash flow, followed by a minimum rate of return and the perceived degree of the risk (Figure 60).

The factor receiving the lowest score in terms of importance was comparative returns on alternate investments.

**Figure 56**

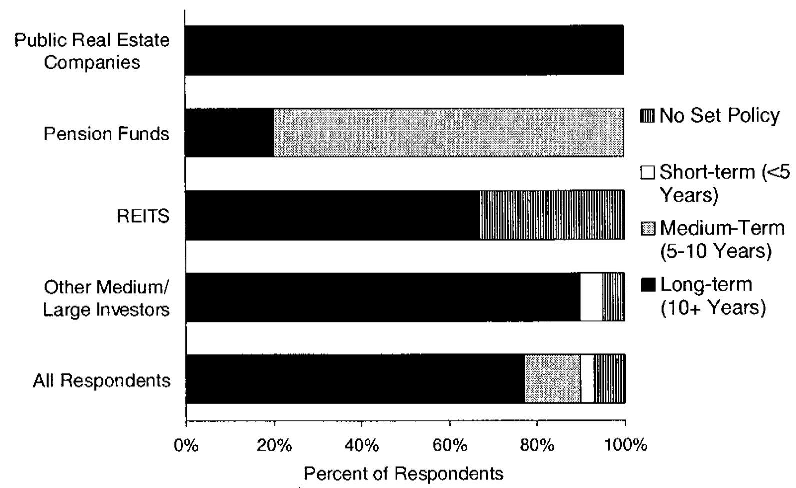
**Profile of Rental Investors: Factors in the Decision-Making Process**

| | Small Investors | Public Real Estate Cos. | Pension Funds | REITs | Other Medium & Large Investors |
|---|---|---|---|---|---|
| **Holding Period** | Typically longer-term, but may be short-term in specific market circumstances | Long-term (10+ Years) | Medium-term (5-10 Yrs) | Long-term (10+ Years) | Typically long-term (10+ years) |
| **Relative Importance of Various Factors in Decision-Making Process** | **Key reasons for investing:**<br>- long-term capital gains,<br>- to supplement income<br>- to assist with mortgage payments | **Most Often Cited "Top of Mind":**<br>- Location<br>- Quality/condition<br>- Potential for capital gains<br><br>**Highest rated:**<br>- Cash flow<br>- Interest rates/ financing<br>- Minimum rate of return<br><br>**Lowest rated:**<br>- Returns on alternate investments | **Most Often Cited "Top of Mind":**<br>- Location<br>- Quality/condition<br>- Returns<br>- Unit prices<br><br>**Highest rated:**<br>- Degree of risk<br>- Current market conditions<br><br>**Lowest rated:**<br>- Interest rates/ availability of financing | **Most Often Cited "Top of Mind":**<br>- Returns<br>- Quality/condition<br>- Potential for higher rents<br>- Potential for capital gains<br><br>**Highest rated:**<br>- Cash flow<br>- Minimum rate of return<br><br>**Lowest rated:**<br>- Government policy<br>- Returns on alternate investments | **Most Often Cited "Top of Mind":**<br>- Location<br>- Returns<br>- Quality/condition<br><br>**Highest rated:**<br>- Cash flow<br>- Degree of risk<br><br>**Lowest rated:**<br>- Returns on alternate investments |
| **Perceived advantages of Rental Investment** | Not available | **Most Often Cited "Top of Mind":**<br>- Stable cash flow<br>- Need for housing<br>- Financing available | **Most Often Cited "Top of Mind":**<br>- Stable cash flow<br>- Low risk | **Most Often Cited "Top of Mind":**<br>- Stable cash flow | **Most Often Cited "Top of Mind":**<br>- Stable cash flow<br>- Low risk<br>- Many diverse tenants |
| **Perceived Disadvantages of Rental Investment** | Not available | **Most Often Cited "Top of Mind":**<br>- Need for capital upgrades<br>- Government intervention<br>- High property taxes | **Most Often Cited "Top of Mind":**<br>- Need for capital upgrades<br>- Management intensive<br>- High property taxes | **Most Often Cited "Top of Mind":**<br>- High property taxes<br>- Government intervention<br>- Lower rates of return<br>- High unit prices | **Most Often Cited "Top of Mind":**<br>- High property taxes<br>- Government intervention<br>- Need for capital upgrades<br>- Rent control/review |

Source: Clayton Research and Fish Marks Jenkins based on information from a variety of sources (see text)

**Figure 57**

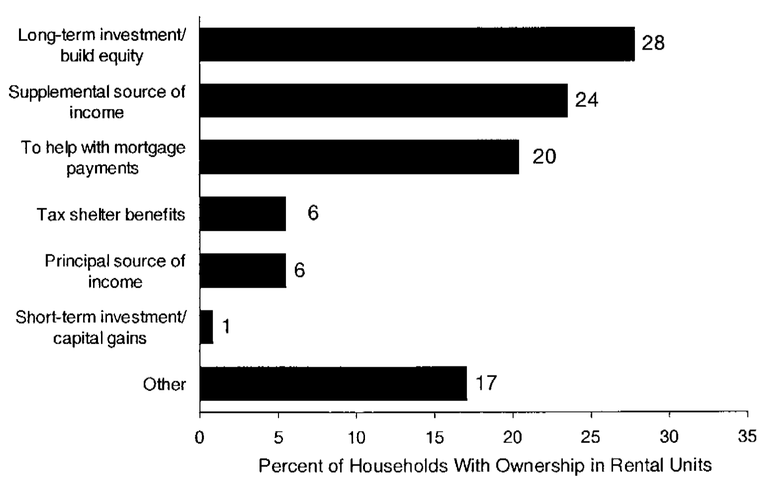
## Holding Period for Rental Investment




Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

**Figure 58**

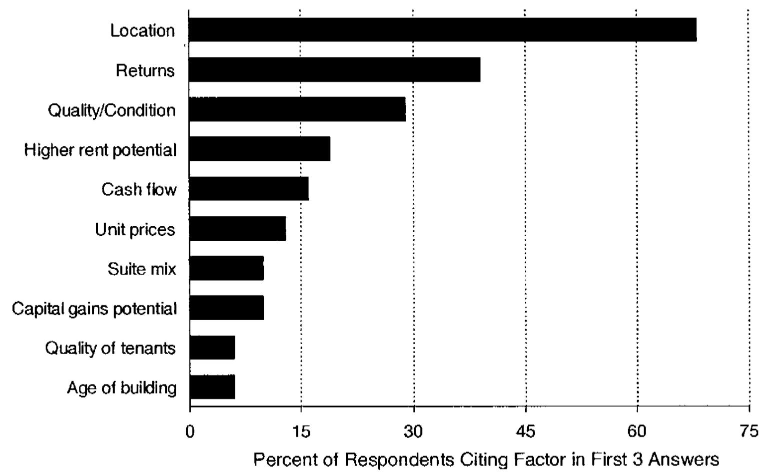
## Main Reason for Owning Rental Units Small Investors




Source: Custom research commissioned by CMHC on The FIRM Residential Mortgage Survey March 1998 (Q16)

**Figure 59**

## Key Factors in the Decision-Making Process
## Top of Mind Responses




Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

**Table 7**

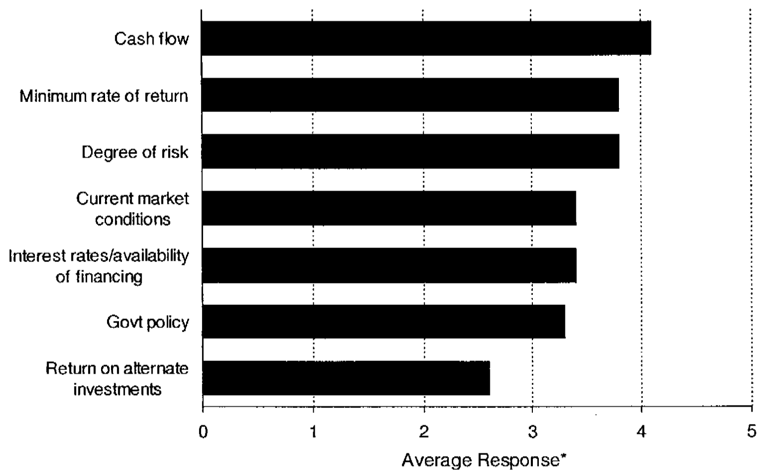
## Key Factors in the Decision-Making Process
## Top of Mind Responses by Type of Investor

| | Public Real Estate Cos. | Pension Funds | REITs | Other Medium & Large Investors | All Investors |
|---|---|---|---|---|---|
| | *% of Respondents Citing Factors in First 3 Responses** | | | | |
| Location | 75 | 60 | 0 | 82 | 68 |
| Returns | 0 | 40 | 67 | 47 | 39 |
| Quality/condition | 50 | 40 | 33 | 18 | 29 |
| Potential for higher rents | 25 | 0 | 33 | 12 | 19 |
| Cash flow | 25 | 20 | 33 | 12 | 16 |
| Unit prices | 0 | 40 | 0 | 12 | 13 |
| Suite mix | 0 | 20 | 0 | 12 | 10 |
| Potential for capital gains | 50 | 0 | 0 | 6 | 10 |
| Quality of tenants | 0 | 20 | 0 | 6 | 6 |
| Age of building | 0 | 20 | 0 | 6 | 6 |

* Some respondents provided only 1 or 2 factors
Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

**Figure 60**

## Rating of Importance of Selected Key Factors in the Decision-Making Process




* On scale of 1 to 5, where 1 is not important and 5 very important

Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

**Table 8**

## Rating of Importance of Selected Key Factors in the Decision-Making Process by Type of Investor

| | Public Real Estate Cos. | Pension Funds | REITs | Other Medium & Large Investors | All Investors |
|---|---|---|---|---|---|
| | *Average Response** | | | | |
| Cash flow | 4.8 | 3.6 | 4.7 | 4.2 | 4.1 |
| Minimum rate of return | 3.8 | 3.6 | 4.7 | 3.8 | 3.8 |
| Degree of risk | 3.3 | 3.8 | 4.3 | 4.1 | 3.8 |
| Current market conditions | 3.5 | 3.8 | 3.7 | 3.3 | 3.4 |
| Interest rates/avail. of financing | 4.3 | 1.6 | 4.0 | 3.5 | 3.4 |
| Government policy | 3.0 | 3.2 | 3.3 | 3.3 | 3.3 |
| Return on alternate investments | 1.8 | 2.2 | 3.3 | 2.9 | 2.6 |

* On scale of 1 to 5, where 1 is not important and 5 very important
Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

For some factors, the relative importance varied among different investor groups (Table 8).

For example, interest rates and availability of financing were of relatively low importance for the pension funds - a reflection of the fact that generally their deals are all cash. For the public real estate companies, on the other hand, this factor has above average importance.

**Perceived Advantages and Disadvantages of Investment in Private Rental Housing**

This section explores the advantages and disadvantages of investment in private rental housing vs. other types of real estate.

***Advantages***

The advantage most often cited (up to three advantages were recorded) was the stable cash flow offered by rental investment (Figure 61).

The more stable cash flow relative to other types of real estate is in large part a function of lower, less volatile vacancy rates. In each of the 6 markets selected for special attention in this study, the rental vacancy rate at present is generally well below that in most other real estate sectors (Table 10) - even in those centres with relatively high rental apartment vacancy rates.

And fluctuations in rental vacancy rates - as illustrated by data for the Toronto area - have generally been less pronounced than for other types of real estate (Figure 62). The result is that it is much easier to accurately project future income streams.

The low level of risk relative to other types of real estate was the second most often cited advantage. This lower level of risk is a product of several of the other advantages cited, including lower vacancy rates, the fact that there are many, small tenants, and the on-going need for housing.

There is some variation in perceived advantages by type of investor (Table 9). For example, the pension funds and the REITs more often cited the benefits of portfolio diversification and prices below replacement costs as advantages.

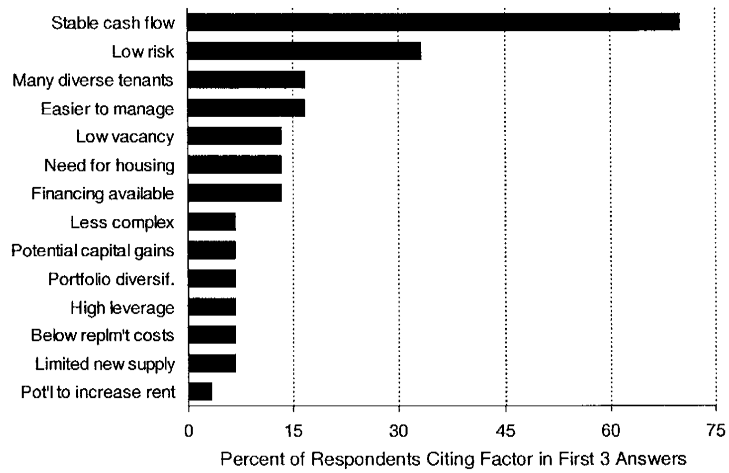
***Disadvantages***

The most often cited disadvantage of rental apartment investment versus other types of real estate was the condition of the stock, and the need for extensive investment in capital upgrades (Figure 63). Rounding out the top three choices were high property taxes for rental housing and the extent of government intervention.

By type of investor (Table 11), the potential need for capital upgrades was of greater concern to the public real estate companies and the pension funds than other investors. The perception that rental investment is more management intensive than other types of real estate (i.e. many, small tenants) was of greater concern to the pension funds.

**Figure 61**

## Advantages of Investment in Private Rental Housing Vs. Other Types of Real Estate




Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

**Table 9**

## Perceived Advantages of Investment in Private Rental Housing Vs. Other Investments by Type of Investor

| | Public Real Estate Cos. | Pension Funds | REITs | Other Medium & Large Investors | All Investors |
|---|---|---|---|---|---|
| | *% of Respondents Citing Factors in First 3 Responses** | | | | |
| Stable cash flow | 75 | 100 | 67 | 56 | 70 |
| Low risk | 0 | 60 | 0 | 44 | 33 |
| Many diverse tenants | 25 | 0 | 33 | 19 | 17 |
| Easier to manage | 25 | 20 | 0 | 13 | 17 |
| Low vacancy | 25 | 0 | 33 | 13 | 13 |
| Need for housing | 50 | 0 | 0 | 13 | 13 |
| Financing available | 50 | 0 | 0 | 13 | 13 |
| Less complex to understand | 0 | 0 | 0 | 13 | 7 |
| Potential capital gains | 0 | 0 | 0 | 13 | 7 |
| Portfolio diversification | 0 | 20 | 33 | 0 | 7 |
| High leverage opportunity | 0 | 0 | 33 | 0 | 7 |
| Below replacement costs | 0 | 20 | 33 | 0 | 7 |
| Limited new supply | 25 | 20 | 0 | 0 | 7 |
| Potential for rent increases | 0 | 0 | 0 | 6 | 3 |

* Some respondents provided only 1 or 2 advantages
Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

Table 10

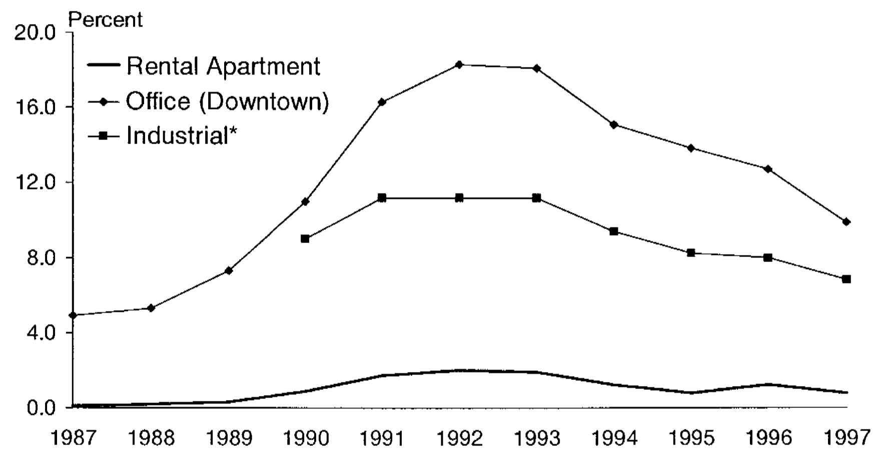
**Comparison of Vacancy Rates by Type of Real Estate Selected Major Markets, 1997**

| | Halifax | Montreal | Toronto | Winnipeg | Calgary | Vancouver |
|---|---|---|---|---|---|---|
| **Rental*** | 8.2% | 6.6% | 0.8% | 5.8% | 0.5% | 1.5% |
| **Office** | 13.3% | 15.5% | 11.9% | 8.9% | 3.8% | 6.5% |
| **Industrial** | 14.7% | 8.3% | 7.6% | 3.0% | 1.5% | 4.5% |
| **Retail** | 9.6% | 4.4% | 5.9% | 7.7% | 5.1% | 3.9% |

* Private rental structures of 6 or more units
Source: Clayton Research based on Colliers International and CMHC data

Figure 62

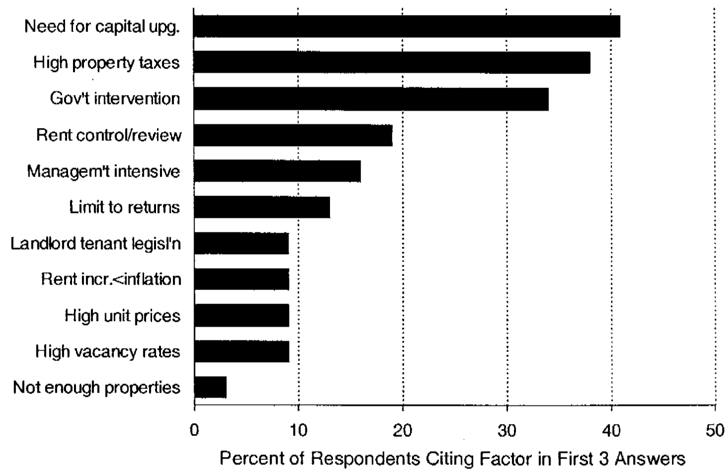
**Vacancy Rates in Selected Real Estate Sectors Toronto**




* Not available prior to 1990
Source: Clayton Research based on data from CMHC and Colliers

**Figure 63**

## Disadvantages of Investment in Private Rental Housing Vs. Other Types of Real Estate




Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

**Table 11**

## Perceived Disadvantages of Investment in Private Rental Housing Vs. Other Investments by Type of Investor

| | Public Real Estate Cos. | Pension Funds | REITs | Other Medium & Large Investors | All Investors |
|---|---|---|---|---|---|
| | *% of Respondents Citing Factors in First 3 Responses** | | | | |
| Need for capital upgrades | 75 | 80 | 0 | 22 | 41 |
| High property taxes | 50 | 40 | 33 | 39 | 38 |
| Government intervention | 75 | 0 | 33 | 28 | 34 |
| Rent control/review | 25 | 20 | 0 | 22 | 19 |
| Management intensive | 25 | 40 | 0 | 11 | 16 |
| Lower rates of return | 25 | 20 | 33 | 6 | 13 |
| Landlord tenant legislation | 0 | 0 | 0 | 17 | 9 |
| Rent increases below inflation | 0 | 0 | 0 | 17 | 9 |
| High unit prices | 0 | 0 | 33 | 11 | 9 |
| High vacancy rates at present | 0 | 0 | 0 | 17 | 3 |
| Not enough good properties | 0 | 0 | 0 | 6 | |

* Some respondents provided only 1 or 2 disadvantages
Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

## Financing Arrangements and Attitudes

This section examines the financing arrangements used by different types of investors in private rental housing, including the role of mortgage insurance. The results are summarized on Figure 64.

### Small Investors

The majority of small investors have downpayments of less than 25% when purchasing rental units (Figure 65). As such they generally require mortgage insurance.

When asked why they used mortgage insurance as part of the custom FIRM research conducted for this study, small investors most often indicated that it was because "the lender told me to" (Figure 66).

### Public Real Estate Companies

The size of downpayments used to acquire buildings varies from case to case, but the interviews conducted for this study suggest that typically downpayments are below 25%. Therefore typically mortgage insurance is required. This group, however, is also attracted to mortgage insurance because of the lower interest rates available.

### Pension Funds

Typically pension funds purchase rental properties on a cash basis (i.e. 100% equity). Therefore, financing/mortgage insurance are not required.

**Figure 64**

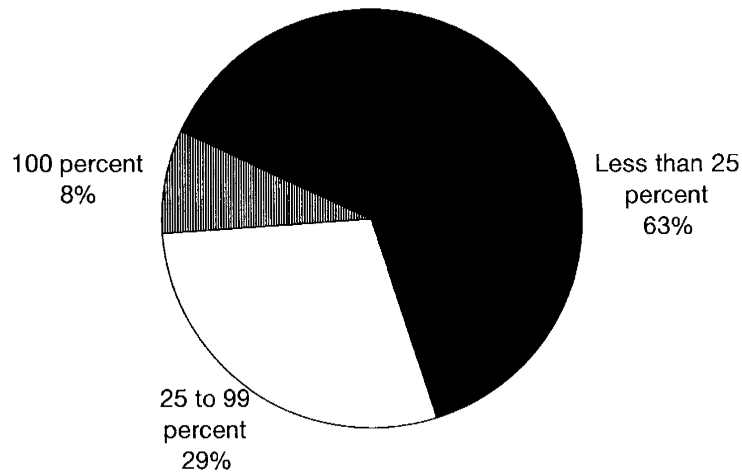
**Profile of Rental Investors: Financing Arrangements and Attitudes**

| | Small Investors | Public Real Estate Cos. | Pension Funds | REITs | Other Medium & Large Investors |
|---|---|---|---|---|---|
| **Downpayment Ratios** | Majority have downpayments of less than 25% | Varies, but typically below 25% | Usually 100% | Varies, but typically 25% | Varies; more than half typically put down at least 25% |
| **Sources of Financing** | Typically banks, trust, credit unions | Typically banks, trust, life insurance cos. | Not required | Typically banks, trust, life insurance cos. | Typically banks, trust, life insurance cos. |
| **CMHC Mortgage Insurance:** | | | | | |
| ***Typically Use?*** | Majority do so | Typically yes | No | Typically yes | Majority of those interviewed indicated no, or only sometimes |
| ***Why Yes?*** | Top reason is because lender tells them to; less important are getting a lower interest rate and lack of equity | Lower rate | | Lower rate | Lower rate<br>Lender required |
| ***Why No?*** | | | Not required - no mortgage | | Cost/premium increases cited most often |

Source: Clayton Research and Fish Marks Jenkins based on information obtained from structured interviews and other sources

**Figure 65**

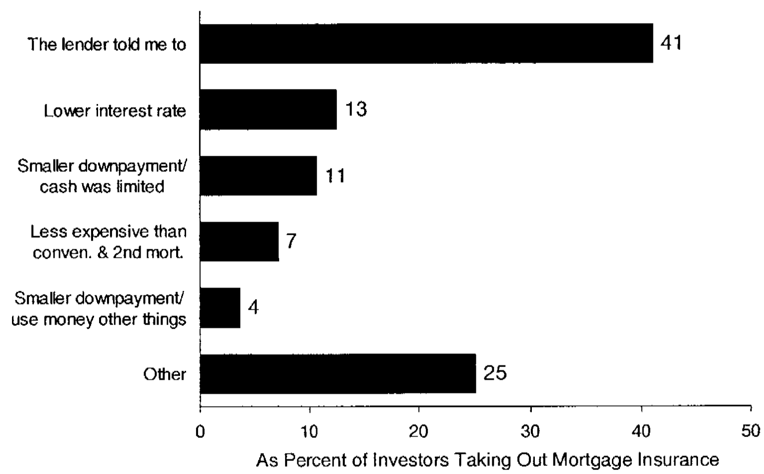
## Size of Downpayment
## Small Rental Investors




Source: Custom research commissioned by CMHC on The FIRM Residential Mortgage Survey
March 1998 (Q16)

**Figure 66**

## Main Reason Why Obtained Mortgage Insurance
## Small Investors




Source: Custom research commissioned by CMHC on The FIRM Residential Mortgage Survey
March 1998 (Q16)

#### REITs

Downpayment ratios can vary for purchases by the REITs, but discussions with this group suggest that typically they are at least 25 percent. The REITs nonetheless tend to obtain CMHC mortgage insurance, in order to obtain a lower mortgage rate.

#### Other Medium and Large Investors

Downpayment ratios vary for this group, but among those investors interviewed, over half typically put down at least 25%, and did not obtain CMHC mortgage insurance.

The main reason cited for not obtaining mortgage insurance was that the costs/premiums were too high, particularly since the increases in 1996.

For those who did take out mortgage insurance usually, or sometimes, the main reasons were to obtain a lower interest rate, or because the lender required it.

## Financial Performance

This section examines the financial performance of investors in private rental housing. The focus is on investment in the existing stock - new rental unit development is considered in Chapter 5.

### Methods of Measuring Returns

There is no comprehensive information available to measure returns to rental investment.

In part, this reflects the fact that there is not one single, universally accepted method of measuring returns. Various methods are generally divided into two main groups: single period measures and multi-year, or discounted cash flow, measures.

Single period measures evaluate the income or cash flow of an investment over only a portion of the investor's holding period - usually a single year. The advantage of these measures are that they are relatively easy to calculate, and do not require a scenario of the future. The two most common examples are:

- **Capitalization Rate ("Cap Rate")**: this is the ratio of the net operating income (NOI), which is revenues minus expenses before debt payment, to the purchase price of the property. It is also referred to as the **return on investment** (ROI).
- **Cash-on-Cash Return (C on C):** this is the ratio of the cash flow (net operating income less debt payments) to the initial equity.
- **Total return:** this measure relates the total of net income and capital appreciation in a period to the value of the property in the base year. It typically assumes no debt financing. The Russell Canadian Property Index measures total returns.

Discounted cash flow, or multi-year measures, measure returns over a multi-year holding period, in present value terms. Common examples include:

- **Net present value** (NPV): the value of the future income streams in current dollars;
- **Internal rate of return** (IRR): the rate of return which equates the discounted value of the cash flow and the after-tax equity residual to the initial equity investment. The calculation can be done both for before and after tax cash flow.

As part of the discussions with investors, they were asked how they typically measure returns.

Cash flow, either on its own, or calculated as a return on equity, is the most common method of measuring returns, followed by cap rates (Figure 67).

Few respondents indicated they used internal rate of return or total return (which takes capital appreciation into account).

The methods used to measure returns vary by investor group (Table 12), as discussed below:

- **Small investors**: while not asked as part of the FIRM research, small investors by their nature typically would not use sophisticated methods of calculating returns, if they do so at all. Cash flow would likely be the most common measure, or perhaps for some, net operating income.
- **Public real estate companies**: the public real estate companies typically measure returns based on cap rates or cash-on-cash returns.
- **Pension funds**: pension funds typically measure returns based on the total return (income and capital appreciation). IRR is also used.
- **REITs**: The REITs indicated that they use a combination of measures, most often cap rates, but also cash flow and cash-on-cash return. Earnings per unit/share would be another indicator of returns.
- **Other medium and large investors**: cash flow, either alone, or expressed in relation to equity (cash-on-cash return) are the most common measures used by other investors.

**Figure 67**

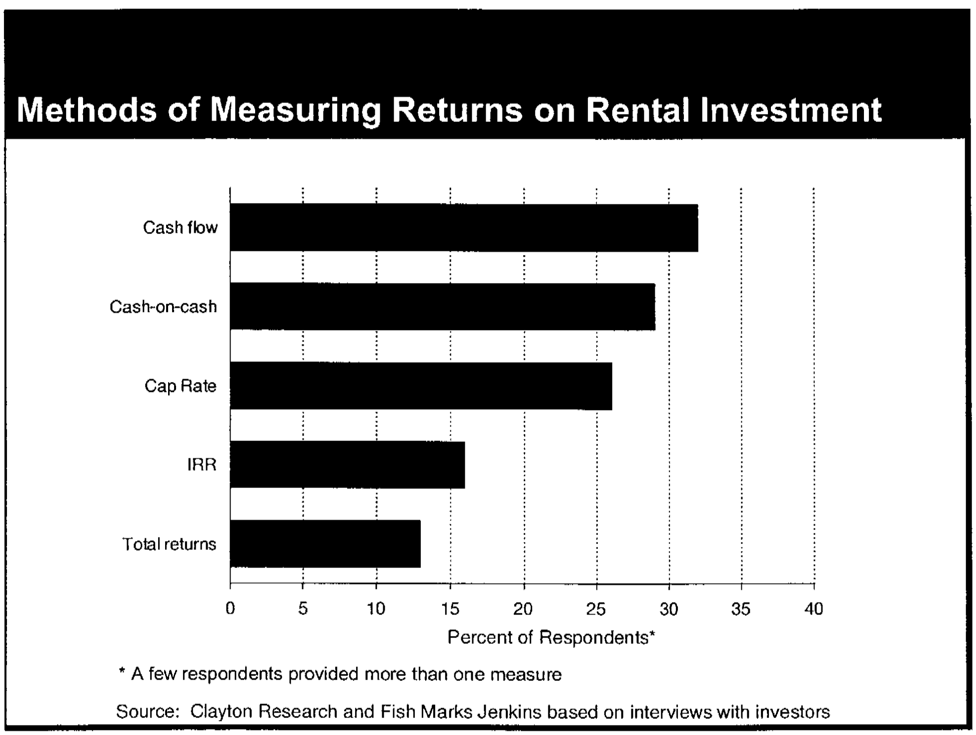


Table 12

**Methods of Measuring Returns on Rental Investment by Type of Investor**

| | Public Real Estate Cos. | Pension Funds | REITs | Other Medium & Large Investors | All Investors |
|---|---|---|---|---|---|
| | *Percent of Respondents** | | | | |
| Cash flow | 0 | 0 | 25 | 50 | 32 |
| Cash-on-cash | 50 | 0 | 25 | 33 | 29 |
| Cap rate | 50 | 20 | 50 | 17 | 26 |
| IRR | 0 | 40 | 25 | 11 | 16 |
| Total returns | 0 | 60 | 0 | 6 | 13 |

* A few respondents provided more than 1 measure
Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

### What Returns Are Being Achieved?

As part of the interviews, investors were asked what returns they were achieving on their rental portfolios. However, given the reluctance of some to share this information, as well as the range of difficult measures used, the exercise did not prove as fruitful as hoped.

Therefore, to gain some insight into the types of returns being achieved, different sources of information were consulted:

- **Cap rate** information from Colliers by major market;
- **Derived cash-on-cash returns** for the 6 major markets, based on information on average sales prices and net income, and assumptions as to typical financing arrangements as gleaned from the interviews.
- **Total returns** as per the Russell Canadian Property Index - these are most applicable to pension fund investors.

Each is reviewed in the following sections.

### *Cap Rates*

According to data from Colliers, rental cap rates in 1997 in the 6 markets selected for special examination in this study ranged from a low of 7.5% in Vancouver to 10.5% in Halifax (Table 13). In general, these are below the cap rates for other types of real estate in these centres, the key exceptions being lower cap rates in the office sectors in Toronto, Calgary and Vancouver.

Rental cap rates declined in most of the markets in 1997 (Figure 68). This reflects the increase in prices which occurred in response to increased activity, and fewer distressed sales.

Cap rates in Vancouver have been consistently below the other centres in the 1990s. Relatively high unit costs are the primary reason (as will be shown later, on Table 14).

Information for the U.S. suggests that rental cap rates there have typically been in the 8.5% to 9.5% range in recent years .

**Table 13**

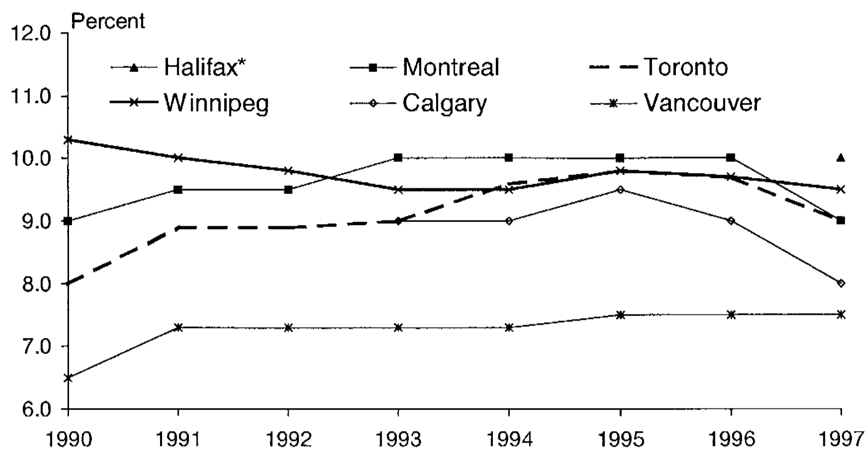
**Comparison of Cap Rates by Type of Real Estate Selected Major Markets, 1997**

| | Halifax | Montreal | Toronto | Winnipeg | Calgary | Vancouver |
|---|---|---|---|---|---|---|
| **Rental** | 10.50% | 9.50% | 9.20% | 9.50% | 8.00% | 7.50% |
| **Office (CBD)** | 10.50% | 9.75% | 8.25% | 10.75% | 7.75% | 7.25% |
| **Industrial** | 11.50% | 11.00% | 9.80% | 10.50% | 9.25% | 8.75% |
| **Retail** | 11.00% | 10.50% | 10.20% | 10.50% | 9.50% | 9.25% |

Source: Clayton Research based on Colliers International data

**Figure 68**

**Trends in Cap Rates for Rental Properties Selected Major Markets**




* Halifax data only available for 1997

Source: Clayton Research based on data from Fish Marks Jenkins and Colliers

### *Cash-on-Cash Returns*

Information on average selling prices per unit in 1997, combined with information on net annual operating income and cap rates, were used to examine the potential financial performance on buildings recently purchased in the 6 major markets under review in this study (Table 14).

In each case, it is assumed that 15% equity is used, and that CMHC insurance is obtained (at a premium of 3%) in order to obtain a lower interest rate. Note that since the analysis is based on recent, not future, transactions, the current CMHC policies for existing units are used, not the changes which will be introduced January 1, 1999.

The results suggest that cash-on-cash returns on recent investment vary substantially by market, ranging from less than 10% in Vancouver and Calgary to over 20% in Halifax.

A similar analysis was done to assess how returns may vary by type of investor (Table 15). Due to lack of comprehensive data for other markets, the analysis was limited to the Toronto market, and includes sales since 1990 in order to provide a larger sample for the smaller investor groups (i.e. the real estate companies, pension funds and REITs). Key input assumptions re: financing vary as per the "typical" behaviour of each group as determined during the discussions with investors (refer back to Figure 64).

**Table 14**

**Summary of Potential Financial Performance on Existing Rental Housing Selected Major Markets**

| | Halifax | Montreal | Toronto | Winnipeg | Calgary | Vancouver |
|---|---|---|---|---|---|---|
| **Key Input Assumptions:** | | | | | | |
| Average Price Per Suite* | $48,500 | $31,500 | $54,000 | $28,500 | $48,000 | $72,500 |
| Net Annual Operating Income* | $5,088 | $2,988 | $4,968 | $2,708 | $3,840 | $5,438 |
| Financing Assumptions: | | | | | | |
| Equity Ratio | 15.0% | 15.0% | 15.0% | 15.0% | 15.0% | 15.0% |
| Amortization Period (Years) | 25 | 25 | 25 | 25 | 25 | 25 |
| Interest Rate | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| CMHC Insured | Yes | Yes | Yes | Yes | Yes | Yes |
| CMHC Premium | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% |
| **Financial Performance:** | | | | | | |
| Cap Rate | 10.5% | 9.5% | 9.2% | 9.5% | 8.0% | 7.5% |
| Cash Flow | $1,828 | $871 | $1,338 | $792 | $614 | $564 |
| Cash-on-Cash | 25.1% | 18.4% | 16.5% | 18.5% | 8.5% | 5.2% |

* Average from sample of transactions in each market in 1997
Source: Clayton Research based on data from Fish Marks Jenkins and Colliers.

**Table 15**

**Summary of Potential Financial Performance on Existing Rental Housing by Type of Investor, Toronto**

| | Public Real Estate Co. | Pension Fund | REIT | Other |
|---|---|---|---|---|
| **Key Input Assumptions:** | | | | |
| Average Price Per Suite* | $57,500 | $77,000 | $50,500 | $45,000 |
| Net Annual Operating Income* | $5,292 | $6,540 | $4,596 | $4,056 |
| Financing Assumptions: | | | | |
| Equity Ratio | 15.0% | 100.0% | 25.0% | 25.0% |
| Amortization Period (Years) | 25 | -- | 25 | 25 |
| Interest Rate | 6.0% | -- | 6.0% | 6.5% |
| CMHC Insured | Yes | -- | Yes | No |
| CMHC Premium | 3.0% | -- | 1.5% | -- |
| **Financial Performance:** | | | | |
| Cap Rate | 9.2% | 8.5% | 9.1% | 9.0% |
| Cash Flow | $1,427 | $6,540 | $1,644 | $1,343 |
| Cash-on-Cash Return | 16.5% | 8.5% | 13.0% | 11.9% |

* Average from sample of transactions since 1990
Source: Clayton Research based on data from Fish Marks Jenkins and interviews with investors.

The results indicate that in general cap rates have not varied substantially by type of investor in the Toronto market. The slightly lower cap rate shown for pensions funds may reflect the competition for good quality properties and the upper pressure on prices which resulted.

Cash-on-cash returns, however, show greater variation. The lowest cash-on-cash return is for pensions funds - which corresponds to the lack of leverage (i.e. 100% equity). Higher than average cash-on-cash returns are indicated for the public real estate companies and REITs.

### *Total Returns*

Only the pension funds indicated that they regularly look at total returns on their investment - that is, both income and capital appreciation.

The most widely used indicator to measure total returns on real estate investment is **the Russell Canadian Property Index**. Indexes by type of real estate are constructed based on project information provided by participating institutional investors.

The index for each type of real estate contains an **income** component (which expresses net operating income over the period under consideration as a percent of the appraised value at the beginning of the period) and a **capital** component, which expresses the change in the appraised value over the period under consideration as a percent of the value at the beginning of the period. The **total** return is the sum of the income return and the capital return.

There are substantial limitations to this series. First, the sample for apartments is very small - for the 1997 data only 47 properties Canada-wide - and the properties are not necessarily representative of the rental stock in general. Second, the limitations of appraisal-based indexes, such as the Russell Property Index and its equivalent in the U.S., the NCREIF property index, have been widely documented.

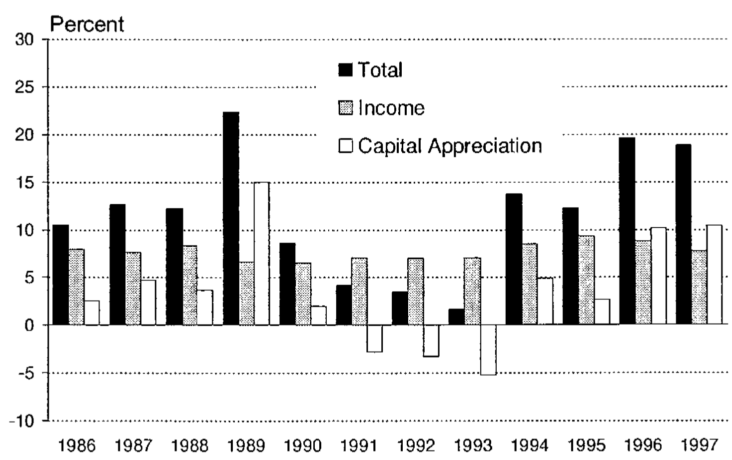
In particular, appraisals are based on viewed transactions. If many properties have been selling, then there is a better sense of the market value of a building. In a climate of fewer, or no, comparable sales, "market value" is more difficult to determine.

Despite its limitations, as the pension funds have indicated that they do rely on the Russell Index to measure their own performance relative to the industry, it is looked at here.

The data illustrate the stable income returns to rental apartment investment (at least for institutional investors), and the wider fluctuation in the capital component, which is more closely linked to market cycles (Figure 69). Again, it must be cautioned that these results have their limitations, and should not be considered to be representative of rental investment in general.

**Figure 69**

**Returns on Rental Apartment Investment, Canada, Institutional Investors**

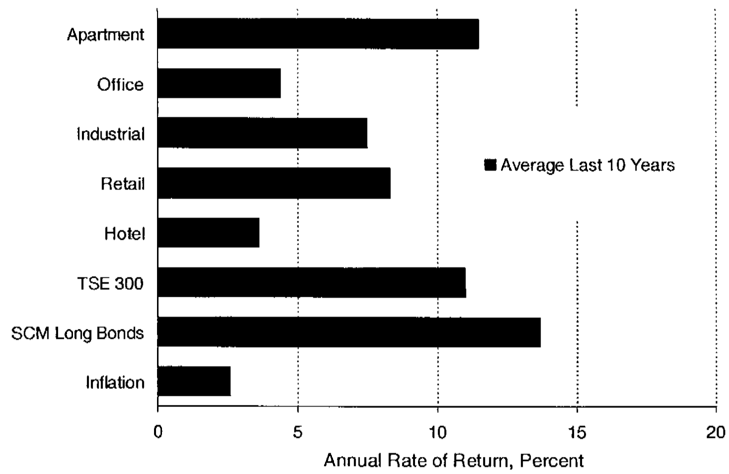



Note: Based on year-over-year changes in the 4th quarter

Source: Clayton Research based on data from the Russell Canadian Property Index

**Figure 70**

## Comparison of Returns of Rental Apartment Investment and Other Types of Investment, Institutional Investors

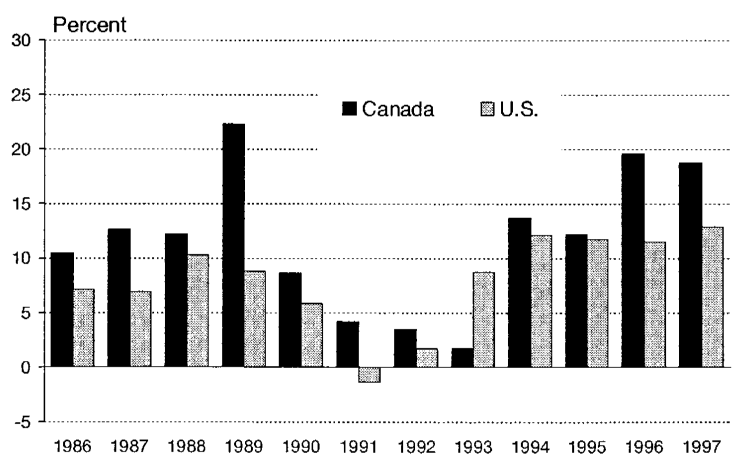



Note: Based on year-over-year changes in the 4th quarter

Source: Clayton Research based on data from the Russell Canadian Property Index

**Figure 71**

## Returns on Rental Apartment Investment Canada and U.S.,* Institutional Investors




* Caution: data for Canada and U.S. not strictly comparable; they are provided here to compare **trends**, not actual levels

Source: Clayton Research based on data from the Russell Canadian Property Index and the NCREIF Property Index

Comparing returns across different real estate sectors since the mid 1980s suggests that the apartments held by institutional investors have performed relatively better than other real estate in their portfolios over the longer-term (Figure 70).

A comparison of Canadian and U.S. total returns (Figure 71) indicates that broad trends in returns on rental investment for institutional investors have been similar between the two counties. As with other comparisons in this report between U.S. and Canadian data, the information is provided to assess relative trends, not to compare levels of returns between the two countries.

## Profile of Investors in Private Rental Housing - Summary of Key Findings

- Small investors play an important role in private rental investment in Canada - this group owns almost half of the private rental stock. While the role of institutional investors - such as public real estate companies, REITs and pension funds - has been growing rapidly in recent years, combined these groups still own less than 5 percent of rental units. The remainder of the private rental stock is in the hands of medium and large investors.
- In general, investors in private rental housing are in it for the longer-term - that is, at least 10 years. The key exception is the pension funds, which tend to take a medium-term (5 to 10 year) view for their investments.
- The factor that investors most often cited as being a key determining factor in the decision-making process was location, followed by the expected rate of return on the project, and the quality/condition of the building.
- The main advantages of investment in rental housing compared to other types of real estate are perceived to be the stable cash flow, and the lower risk. Both of these factors are in large part a function of lower, less volatile vacancy rates than in other sectors. The lower level of risk is also a product the fact that there are many, diverse tenants, and the on-going need for housing.
- The main disadvantages of investment in rental housing compared to other types of real estate are perceived to be the condition of the stock (and the potential need for extensive investment in capital upgrades), high property taxes and the extent of government intervention.
- The most common methods of measuring returns on rental investment are cash flow, cash-on-cash returns and cap rates. Few investors consider "total" returns (i.e. including capital appreciation) on a regular basis.
- Returns being achieved have varied by market. Cap rates for recently purchased existing buildings in the 6 major markets under special review in this study ranged from between 7.5% (Vancouver) to 10.5% (Halifax) in 1997. Cash-on-cash returns varied even more, from less than 10% in Calgary and Vancouver to 25% in Halifax.

# CHAPTER 5 - FOCUS ON INVESTMENT IN NEW PRIVATE RENTAL HOUSING

This chapter focuses more closely on investment in new purpose-built private rental housing.

It begins by developing a profile of investors in new rental housing.

This is followed by an examination of the economics of developing new purpose-built private rental housing. As the economics are specific to individual markets, separate analyses are conducted for each of the 6 major markets selected for special study.

## Profile of Developers of New Rental Housing

In this section, a profile of developers in new private rental housing is developed.

There is no comprehensive information available on the characteristics of developers of purpose-built private rental housing. Therefore, the information here has largely been gleaned from the interviews conducted for this study. While the information is representative of those interviewed, caution should be used in extrapolating the results in a more general sense.

### Characteristics of Developers of New Rental Housing

This section examines some of the basic characteristics of developers of new rental housing.

***Years in Rental Development***

Of those developers interviewed, the majority had been in the rental sector for at least 30 years.

***Strength of Recent Activity***

As discussed earlier, there has been very little new purpose-built private rental units developed in Canada in recent years. Of those developers interviewed for this study, few considered themselves to be currently "active" in developing new rental units, although most were seriously considering becoming active again in the future.

***Size/Characteristics of Rental Portfolio***

The size of the rental portfolios of those developers interviewed for this study ranged from about 250 units to 13,000 units, with the average size just over 4,000 units.

Typically, these units are in high-rise buildings (about 80% vs. 20% low-rise).

The age of rental units held by developers varies, but virtually all are at least 10 years old.

All considered their units to be in "very good" or "excellent" state of repair.

In terms of target markets, for new projects, developers are typically considering the upper income segments. Among their existing properties, however, there is a wider range of tenants.

***Relative Importance of Rental Investment***

All of those developers interviewed are involved in developing other forms of real estate besides rental housing.

The other types of real estate varied widely. Most often, it was other types of residential development (e.g. single-family homes, condominium apartments, land development). However, non-residential development, such as office, retail, hotel and industrial space was also being pursued by some rental unit developers.

On average, income from rental properties accounts for about one-third of the total income among those interviewed.

### *Plans to Expand/Contract Involvement in Rental Housing*

The majority of those interviewed plan to expand their involvement in rental unit development in the future.

A few developers reported having sold off some properties in recent years.

### *Conversion to Condominiums*

Typically, developers are not interested in converting their rental units to condominiums. Only one developer interviewed had converted any of rental buildings in the past to condominiums, and only one is seriously doing so in the future.

## Factors In The Decision-Making Process

This section explores various factors in the decision-making process for developers of new purpose-built private rental units.

### *Holding Period for Investment*

As indicated earlier, those developers interviewed for this study typically build rental units for their own portfolio. As such, they take a long-term view of investment (i.e. more than 10 years).

### *Key Determining Factors in the Decision to Develop*

In the interviews conducted with developers for this study, the factors they take into consideration when deciding whether or not to develop a particular project were explored. Similar to what was done for all investors in Chapter 4, two methods were used. The first sought "top of mind" responses; the second asked respondents to rate the importance of a series of factors on a scale of 1 to 5, where 1 was "not important" and 5 was "very important".

The factor that developers most often cited "top of mind" as being a key determining factor in the decision-making process was the returns or economic viability of the project (Figure 72). This was followed by the location of the project.

Separate from the top of mind responses, developers were asked to rate the importance of selected factors in their decision whether or not to develop a particular project (Figure 73).

The factor which was scored as the highest in importance was financing (i.e. interest rates/availability). Financing was a relatively more important factor for developers than investors in general; for the latter group, cash flow rated highest in importance (refer back to Table 8 in Chapter 4). Developers rated the overall returns/economic viability of the project and, hand-in-hand, cash flow just behind financing in terms of importance.

The factor receiving the lowest score in terms of importance was returns on alternate investments; this is consistent with its relatively low importance indicated among investors in general.

### *Perceived Advantages and Disadvantages of Developing New Private Rental Housing*

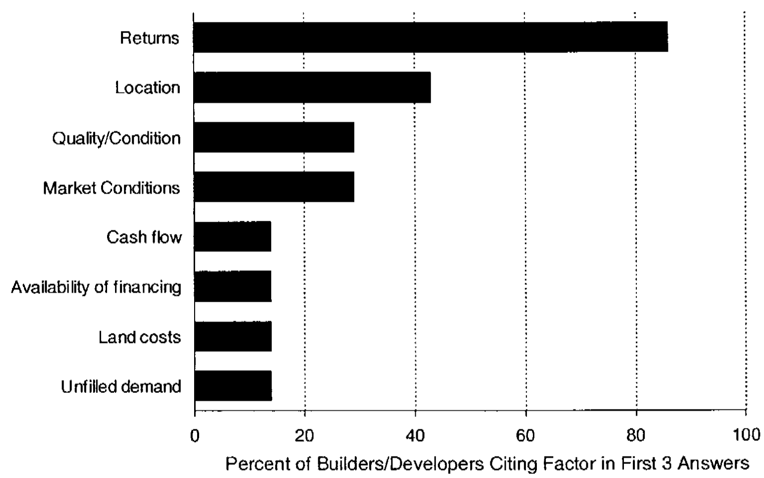
This section explores the advantages and disadvantages of developing new private rental housing versus other types of real estate.

The **advantages** most often cited by those interviewed (up to three advantages were recorded for each) were more stable cash flow and relatively low vacancies (Figure 74). Other top advantages cited were the relatively low level of risk and that it was easier to manage rental properties than other types of real estate.

The most often cited **disadvantages** of developing new rental properties vs. other types of real estate was the role of government - in particular, government intervention and changing government policies (Figure 75). This was followed by high property taxes.

Figure 72

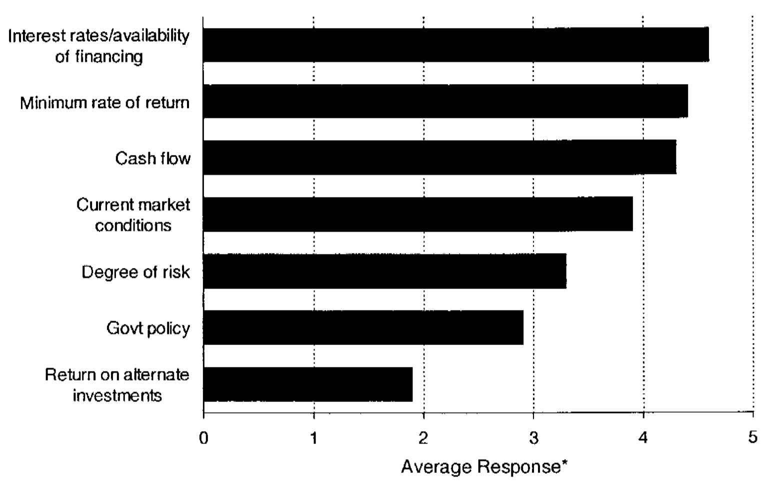
## Key Factors in the Decision-Making Process for New Rental Development, Top of Mind Responses




Source: Clayton Research and Fish Marks Jenkins based on interviews with builders/developers

Figure 73

## Rating of Importance of Selected Key Factors in the Decision-Making Process for New Rental Development

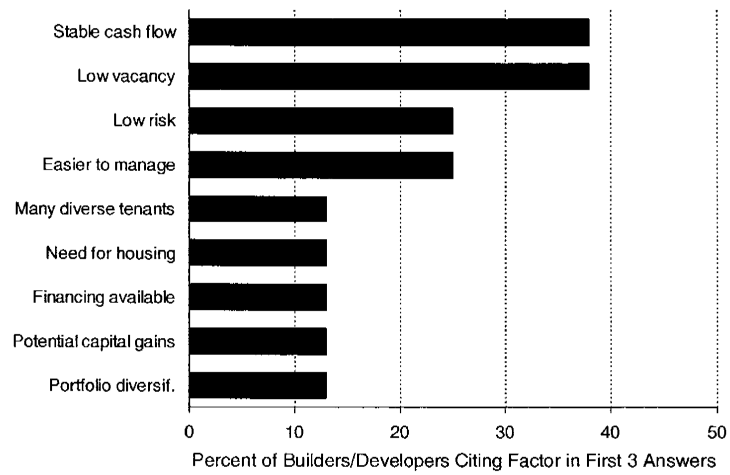



* On scale of 1 to 5, where 1 is not important and 5 very important

Source: Clayton Research and Fish Marks Jenkins based on interviews with builders/developers

**Figure 74**

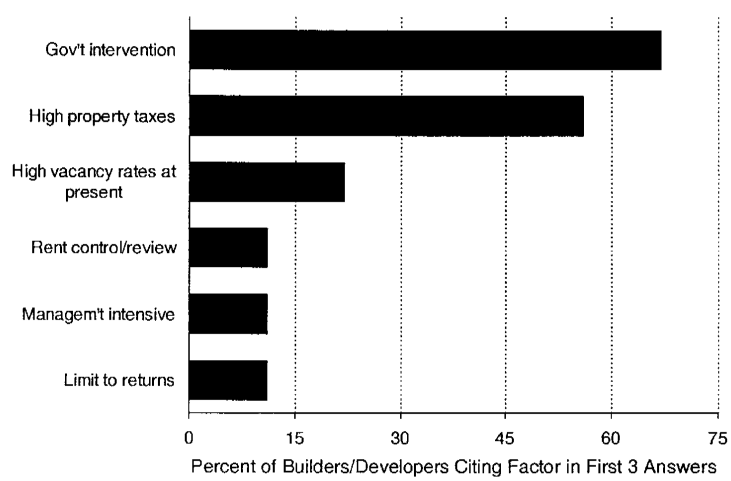
## Advantages of Investment in Private Rental Housing Vs. Other Types of Real Estate




Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

**Figure 75**

## Disadvantages of Investment in Private Rental Housing Vs. Other Types of Real Estate




Source: Clayton Research and Fish Marks Jenkins based on interviews with investors

### Financing Arrangements And Attitudes

This section examines the financing arrangements used by developers of new private rental housing, including the role of mortgage insurance.

*Amount of Equity/Downpayment ratio*

Unlike purchases of existing buildings, the amount of equity put up for a new rental development is a complex issue. As discussed in Chapter 3, the lender (and CMHC) will establish a lending value based on applying a cap rate to the expected net operating income of the project; as the lending value may fall far short of the development costs, the "gap" will need to be made up by the developer by putting up more equity than they might otherwise desire to do.

Of the developers interviewed for this study, the majority indicated that they would typically put down at least 25% of the costs of developing the project.

*Source of Financing*

Typically banks and life insurance companies.

*Use of CMHC Mortgage Insurance*

In general, CMHC insurance is used to finance new rental development. Developers interviewed indicated that the main reasons are because the developer can generally obtain a better mortgage interest rate (at least 50 basis points below the conventional interest rate) and/or the lender required insurance be taken out before providing the financing.

The developers interviewed, while typically using CMHC insurance, had several concerns with it, including:[10]

- The cost of CMHC insurance (currently a premium of 5% if downpayment less than 20% of the lending value);
- The relatively uniform application of premiums and criteria, which many developers felt did not adequately recognize the variation in risk based on track record and specific local market conditions;
- The need for personal covenants;
- The application/approval process, which is considered by many developers to be cumbersome; and
- Certain aspects of the underwriting criteria (such as the minimum 9% interest rate used to determine lending value).

There were mixed views as to whether or not a project having CMHC insurance enhanced its potential value if sold. Some of those interviewed felt that it was beneficial in this respect, as the project had implicitly "obtained CMHC's stamp of approval."[11] Others felt it made no difference.

### Financial Performance

The developers interviewed typically would look for a minimum 15% "cash-on-cash" return before proceeding with a new project.

The economics of developing new rental units - and whether this minimum rate of return is achievable today - is explored in more detail in the next section.

[10] CMHC is currently reviewing its policies related to mortgage insurance for new rental properties.

[11] It should be emphasized that this in no way implies that CMHC mortgage insurance actually guarantees the quality of the project for the investor. CMHC mortgage insurance only protects the lender against mortgage default.

## The Economics of Investment in New Private Rental Housing

The analysis in this section draws in part on the information gleaned from the interviews with developers of new rental housing (those either currently active or previously active, as well as those contemplating future activity), information from other contacts as well as previous studies of the economics of private rental development.

Ideally, one would like to at least in part base the analysis on actual project information for recent rental development. However, as shown earlier, there has been relatively little private rental construction in recent years in the 6 major centres examined in this report, nor in general throughout Canada. Although much of this can be attributed to the non-viability (in an economic sense) of rental construction at this time, there are some other local factors that also come into play. These include an oversupplied market overall in the Halifax CMA and the relative attractiveness of condominium development in Toronto and Vancouver.

Moreover, the insights that could be gained from an examination of the few private rental projects that have been built are often not very useful in understanding the situation faced by the typical developer/investor contemplating the pros and cons of new private rental development. This is because individual projects that have actually gone ahead in recent years are often "aberrations", based on a set of special circumstances. These special circumstances can occur for a variety of reasons, such as:

- Artificially low land costs where a developer has held the land for some time, and has written down the book cost of the land;
- Unusually low development costs where certain costs have already been paid; and
- The use of financing schemes that are not widely applicable.

For each of the major markets examined, while new rental development may be feasible on a very limited number of sites with a particular set of circumstances, the economic viability of rental development in general is still tenuous at best.

### The Interest is There

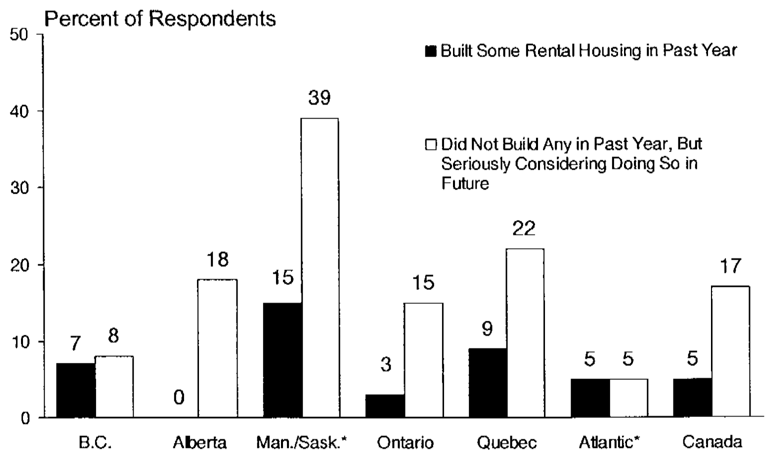
There appears to be increased interest in developing new rental units. The Spring/Summer 1998 CHBA **Pulse Survey of Home Builders** showed that while only 5 percent of respondents had built rental housing in the past year, another 17 percent were seriously considering doing so in the future (Figure 76). For those who weren't considering it, the main reasons were the perception of too much government intervention, and the poor economics (Figure 77).

The interviews conducted specifically for this study also confirmed that there is certainly interest in developing/purchasing new private rental projects. The reasons include:

- The inherent attractiveness of rental investment compared to investment in other types of real estate (such as its more stable cash flow), as discussed in Chapter 4.
- The lack of quality existing product for institutional investors. A few institutional investors (such as pension funds and the REITs) would like to increase their investment in rental apartments, but are finding it difficult to find properties which meet their quality standards.
- The reduced attractiveness of condominium apartment development. While high land costs has made condominium development in Toronto and Vancouver an attractive alternative for many apartment developers in recent years, the slowdown in the Vancouver economy and the potential oversupply in the Toronto market have reduced the attractiveness of condominium development to some degree in both of these centres.

**Figure 76**

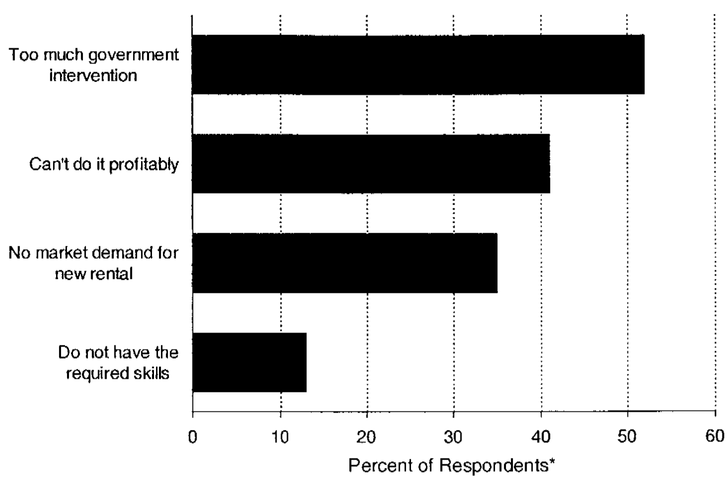
## Current and Expected Rental Housing Activity by Region




Source: CHBA, Pulse Survey of Home Builders, Spring/Summer 1998

**Figure 77**

## Main Reasons for Not Building Rental Housing




* Multiple responses possible
Source: CHBA, Pulse Survey of Home Builders, Spring/Summer 1998

However, the major stumbling block created by the poor economics of rental development (and, to some extent, the regulatory environment) must first be overcome.

### The Proforma Approach

The approach typically used in the analysis of the economics of new rental construction is the construction of **proformas**. These proformas look at the key cost components of development and the relative importance of some of the key input assumptions in the overall economic feasibility of rental construction.

The proformas used in this study are modeled after one used by Clayton Research in a study conducted for CMHC and the British Columbia Housing Management Commission in 1991 entitled **Rental Housing: A Study of Selected Local Markets**, as well as those used in recent studies by Greg Lampert for the Province of Ontario and the former Municipality of Metropolitan Toronto.

The proforma approach allows (to the extent possible) for comparisons to be made of the economics of private rental development between different centres. It also allows for "what if" types of analysis - that is, how do changes in any of the input assumptions affect the final outcome.

### The Key Components of the Proforma

While developers may use a variety of approaches to assess the economic viability of building a particular project, there are certain factors which are critical to the assessment and which would typically be incorporated into any proforma analysis.

These factors are shown on Table 16 which illustrates a hypothetical proforma of a high-rise rental apartment development in the City of Toronto.[12] To facilitate comparisons, the proforma has been constructed to present the analysis on a per unit, rather than total project, basis. As well it is assumed that the project is being developed for the developer's own investment portfolio (rather than for sale to other investors). The key components of the proforma are discussed below.

#### *Underlying Input Assumptions*

This section of the proforma summarizes the key input assumptions that will be used in the analysis, including:

- **Mortgage interest rate** - the actual mortgage rate negotiated for the project. In all scenarios, a five year term is assumed. It is also assumed that the mortgage is insured by CMHC, and that a favourable interest rate of 6% (50 basis points above the Government of Canada 5 year bond rate on average in the first half of 1998) is obtained.
- **Mortgage amortization period** - the total length of time over which the mortgage will be paid off; this is assumed in all scenarios to be 25 years.
- **Loan-to-lending value ratio**: the ratio of the mortgage amount to the value for lending purposes. This is assumed at 80% in all scenarios.[13] This differs from the "% equity", which measures the actual amount of equity

[12] There has been virtually no private rental apartment construction in the Toronto CMA for several years; however, this "theoretical proforma" (based on the input of several local developers, as well as work undertaken by Greg Lampert for the Municipality of Metropolitan Toronto) provides a reasonably good picture of the economics of private rental development in Toronto today.

[13] Although a higher 85% ratio is possible, in general new projects would not be able to meet the 1.1 debt coverage ratio that CMHC requires for a five year term mortgage amortized over 35 years at this loan-to-lending value ratio.

that is put down in relation to the total project cost.
- **Mortgage insurance premium** - in all cases it is assumed that the mortgage obtained is 80% of the lending value, and no construction advances are required, therefore a premium of 3% would apply;
- **GST/HST/QST rates** - current rate of 7% GST; in the analyses for Halifax, this is replaced by the Harmonized Sales Tax (15%); in Montreal, the 7.5% Quebec Sales Tax (QST) is also applied;
- **Cost inflation** - this is the annual rate of increase assumed for operating costs;
- **Rent inflation -** this is the annual rate of increase assumed for rental and other income
- **Initial monthly rent** - the average monthly rent expected be achieved per unit in the first year of operation;
- **Vacancy rate -** assumed to be constant in each year of the analysis (it is also assumed that the project is fully rented up, other than for the vacancy allowance, at the beginning of the first full year of operation.

To simplify comparisons, certain assumptions are kept constant through most of the proformas:

- Cost inflation: 2%
- Rent inflation: 2%
- Vacancy rate: 3%

These are considered to be fairly typical and conservative assumptions. While it may be possible in some centres to achieve higher annual increases in rents, or lower vacancy rates, a prudent investor would opt for conservative assumptions in undertaking the analysis of economic viability.

*Project Development Costs and Financing*

This area of the proforma deals with the development costs of the project, and the financing arrangements.

The project development costs include:

- **Land** - the cost of a serviced block of land;
- **Construction** - hard construction costs plus soft costs;
- **GST/HST/QST** - the amount of the applicable federal and provincial sales taxes that apply to both the land and construction costs.

The financing arrangements include:

- **Equity** - the funds invested directly into the project by the developer;
- **Mortgage** - the difference between the total project costs and the equity;
- **Mortgage insurance premium** (%) - the amount of the insurance premiums, which are assumed to be added to the mortgage principal.

*Revenues and Costs*

This section of the proforma summarizes the on-going revenues and operating costs of the project.

The components of the revenues analysis include:

- **Rental income** - the monthly rent multiplied by 12 months;
- **Other income** - income received from parking (which is often charged separately), laundry facilities and the like which is assumed to be approximately 4.5 percent of the sum of rental and other income;
- **Vacancy allowance** - an adjustment to the rental and other income to account for vacancies;
- **Gross income** - Rental plus other income less the vacancy allowance.

The components of operating costs include:

- Maintenance and operating costs;
- Property taxes.

*Net Operating Income*

- The difference between gross income and operating costs

*Mortgage Payments*

- The mortgage payments are assumed to be blended into equal payments over time and have a principal and interest component.
- The payments are based on the mortgage interest rate and amortization period listed in the input assumptions.
- The initial debt coverage ratio (DCR) is the net operating income divided by mortgage payments. This is also shown based on a 9% mortgage rate and a 35 year amortization period, as the DCR for CMHC insured mortgages must be 1.1 based on these criteria.

*Cash Flow*

- Gross income less operating costs and mortgage payments

*Cash-on-Cash Return*

- The cash flow divided by the equity.

### The Economics of New Rental Investment in Selected Major Markets

This section explores the comparative economic viability of new rental construction in selected major rental markets across Canada. Since the vast majority of new rental development in the major markets under examination has been in apartments, rather than row units, the analysis is limited to this type of development.

*Toronto*

This section explores the economic viability of developing a medium quality 100 unit high-rise apartment building in the central area of the City of Toronto.

Discussions with a sample of developers indicates that in the short to medium term, this is the area that is attracting the most interest and that any new private rental development here is likely to be targeted at the medium to high end of the market. The proforma analysis is based on information obtained from interviews with several developers who have done their own proforma analysis, but have not found it economically feasible to proceed, as well as information contained in other recent studies. All of the Toronto scenarios assume that the building is registered as a condominium, and therefore are in the same property tax class as single-family dwellings.

**Scenario 1** (Table 16) summarizes the situation, assuming that there were no lending restrictions. It assumes a 20% downpayment, and other assumptions as already discussed.

The project under this scenario would incur a negative cash flow in the initial year, and only a moderate positive return after five years - which would not make it an attractive investment. But more importantly, this project would never go ahead because it would not be able to obtain the necessary financing under current lending practices. As outlined in Chapter 3, lenders today are very reluctant to lend on negative cash flow, and CMHC will not insure such a project.

In **Scenario 2** (Table 17), the lending criteria currently in effect are assumed. In this situation, the amount of the mortgage (and consequently the amount of equity required) would be determined by applying a capitalization rate of 9% to the net operating income. In this case, the value for lending purposes would be only just over $90,000 - well below the actual costs of development. With the assumed 80% loan to lending value ratio, total equity of just over $57,000 (about 44% of the project cost) would be required. In this scenario there is a positive cash-on-cash return, but it is a modest one. And the low rate of return is in relation to the relatively large amount of equity required to obtain financing.

**Table 16**

## Proforma for Rental Apartment Construction Toronto, Scenario 1 (No Lending Restrictions)

*Per Unit*

**INITIAL INPUT ASSUMPTIONS**

| | | | |
|---|---|---|---|
| Mortgage interest rate | 6.00% | Cost inflation | 2% |
| Amortization period (yrs) | 25 | Rent inflation | 2% |
| Loan-to-lending value ratio | 80% | Initial monthly rent | $1,050 |
| Mortgage insur. premium | 3.0% | Vacancy rate | 3% |
| GST | 7% | | |

**PROJECT DEVELOPMENT COSTS AND FINANCING**

| Development Costs: | | Financing: | |
|---|---|---|---|
| Land | $25,000 | Equity | $25,894 |
| Construction | $96,000 | Mortgage | $103,576 |
| Subtotal | $121,000 | Total Costs | $129,470 |
| | | *% Equity* | *20.0%* |
| GST | $8,470 | Mortgage Insurance Premium | $3,107 |
| **Total Costs** | **$129,470** | **Total Financing Required** | **$106,683** |

**REVENUES AND COSTS**

| | Year 1 | Year 5 |
|---|---|---|
| **Revenues:** | | |
| Rental income | $12,600 | $13,639 |
| Other Income | $594 | $643 |
| Vacancy allowance | -$396 | -$428 |
| **Gross income** | **$12,798** | **$13,853** |
| **Operating Costs:** | | |
| Maintenance and operations | $3,100 | $3,356 |
| Property taxes | $1,550 | $1,678 |
| **Total operating costs** | **$4,650** | **$5,033** |
| **Net Operating Income** | **$8,148** | **$8,820** |
| *Value for lending purposes** | *$90,532* | |
| *Actual cap rate* | *6.3%* | |
| **Mortgage Payments:** | | |
| Principal | 1,920 | 2,432 |
| Interest | 6,271 | 5,759 |
| **Total** | **8,191** | **8,191** |
| *Initial debt coverage ratio* | *0.99* | |
| *Using 9% interest rate/35 yr. amort.*** | *0.82* | |
| **Cash Flow** | **-43** | **629** |
| **Cash-on-Cash Return** | **-0.2%** | **2.4%** |

* Assuming 9% cap rate ** Must be minimum of 1.1 to meet CMHC criteria

**Table 17**

## Proforma for Rental Apartment Construction Toronto, Scenario 2 (Current Lending Criteria)

*Per Unit*

**INITIAL INPUT ASSUMPTIONS**

| | | | |
|---|---|---|---|
| Mortgage interest rate | 6.00% | Cost inflation | 2% |
| Amortization period (yrs) | 25 | Rent inflation | 2% |
| Loan-to-lending value ratio | 80% | Initial monthly rent | $1,050 |
| Mortgage insur. premium | 3.0% | Vacancy rate | 3% |
| GST | 7% | | |

**PROJECT DEVELOPMENT COSTS AND FINANCING**

| **Development Costs:** | | **Financing:** | |
|---|---|---|---|
| Land | $25,000 | Equity | $57,044 |
| Construction | $96,000 | Mortgage | $72,426 |
| Subtotal | $121,000 | Total Costs | $129,470 |
| | | *% Equity* | *44.1%* |
| GST | $8,470 | Mortgage Insurance Premium | $2,173 |
| **Total Costs** | **$129,470** | **Total Financing Required** | **$74,599** |

**REVENUES AND COSTS**

| | **Year 1** | **Year 5** |
|---|---|---|
| **Revenues:** | | |
| Rental income | $12,600 | $13,639 |
| Other Income | $594 | $643 |
| Vacancy allowance | -$396 | -$428 |
| **Gross income** | **$12,798** | **$13,853** |
| **Operating Costs:** | | |
| Maintenance and operations | $3,100 | $3,356 |
| Property taxes | $1,550 | $1,678 |
| **Total operating costs** | **$4,650** | **$5,033** |
| **Net Operating Income** | **$8,148** | **$8,820** |
| *Initial value for lending purposes** | *$90,532* | |
| *Actual cap rate* | *6.3%* | |
| **Mortgage Payments:** | | |
| Principal | 1,343 | 1,701 |
| Interest | 4,385 | 4,027 |
| **Total** | **5,727** | **5,727** |
| *Initial debt coverage ratio* | *1.42* | |
| *Using 9% interest rate/35 yr. amort.*** | *1.18* | |
| **Cash Flow** | **2,420** | **3,092** |
| **Cash-on-Cash Return** | **4.2%** | **5.4%** |

* Assuming a 9% cap rate  ** Must be minimum of 1.1 to meet CMHC criteria

Faced with low returns, required large amounts of equity, and the relatively more attractive returns achievable on the purchase of existing building (refer back to Table 14), it is apparent why private rental development is virtually non-existent in the Toronto market today.

Three additional scenarios were examined to see what changes might make new rental unit investment in Toronto attractive from a financial performance perspective.The detailed proformas for these scenarios are not shown here, but key results are highlighted on Table 18.

**Scenario 3** assumes that initial achievable rents are 25% higher than under Scenario 2.

Under this scenario, cash flow is greatly improved and cash-on-cash returns are much more in the range that would prompt investors to take new development more seriously. And also very important, the value for lending purposes is up substantially - which means the amount of equity required is greatly reduced relative to Scenario 2.

However, this is a fairly substantial increase in market rents for new units from the current situation. These higher rent levels would not have been achievable under the previous rent control legislation. And, even though rent levels in general are expected to rise under the new Tenant Protection Act, it would be difficult in the near term to achieve higher rents on new projects of this magnitude.

**Table 18**

**Comparison of the Economics of New Private Rental Housing Development Toronto, Alternate Scenarios**

| | Scenario 1: No Lending Restrictions | Scenario 2: With Current Criteria | Scenario 3: 25% Higher Rents | Scenario 4: GST Rebate | Scenario 5: Higher Rents/ GST Rebate |
|---|---|---|---|---|---|
| **Key Input Assumptions:** | | | | | |
| Average Development Costs Per Unit | $129,470 | $129,470 | $129,470 | $126,445 | $126,445 |
| Net Annual Operating Income | $8,148 | $8,148 | $11,347 | $8,148 | $11,347 |
| Value for Lending Purposes | | $90,532 | $126,082 | $90,532 | $126,082 |
| Financing Assumptions: | | | | | |
| Required Equity | 25,894 | 57,044 | 28,604 | 54,019 | 25,579 |
| Equity Ratio | 20.0% | 44.1% | 22.1% | 42.7% | 20.2% |
| Amortization Period (Years) | 25 | 25 | 25 | 25 | 25 |
| Interest Rate | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| CMHC Insured | Yes | Yes | Yes | Yes | Yes |
| CMHC Premium | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% |
| **Financial Performance (Year 1):** | | | | | |
| Cap Rate | 6.3% | 6.3% | 8.8% | 6.4% | 9.0% |
| Cash Flow | -$43 | $2,420 | $3,371 | $2,420 | $3,371 |
| Cash-on-Cash Return | -0.2% | 4.2% | 11.8% | 4.5% | 13.2% |

Source: Clayton Research based on discussion with developers and CMHC

**Scenario 4** assumes that a rebate of the GST is available to developers of rental housing comparable to that on ownership housing (i.e. 2.5% for units valued below $300,000).

Under this scenario, cash flow is improved only marginally compared to Scenario 2 - and equity equal to over 40 percent of the project costs would still be required.

**Scenario 5** assumes the combination of higher rents and a GST rebate. Cash flow is improved somewhat higher than under Scenario 3, boosting returns higher and reducing initial equity. The cash-on-cash return now is much closer to the 15% return that most developers indicated that they were seeking.

These alternate scenarios only touch on the range of possible alternate scenarios that could be explored. An exhaustive analysis in this respect is beyond the scope of the current study.

The analysis does, however, underscore the importance of the monthly rent on the viability of a new rental development in the City of Toronto.

At the same time, it should be recognized that interest rates are relatively favourable at the present time. Any increases in interest rates would have to be offset by still higher rents.

***Vancouver***

The proforma presented in Table 19 is a composite based on information obtained from an actual proforma, as well as information provided on typical proforma inputs obtained from developers of new rental apartments. It is based on a high-rise development of at least 200 units in central Vancouver with a relatively small average suite size, primarily one bedroom units.

The project generates a small positive cash flow in the first year. Although land costs and construction costs are comparable to Toronto, the relative (but not absolute) rent level is higher and the operating costs are lower. These two factors combine in large part to generate a project with a positive cash flow. Nevertheless, the cash flow is relatively modest and would not be attractive to most investors, in light of the large amount of equity required (over 40%).

It is also important to keep in mind that these particular circumstances are not necessarily transferable to a typical development. Based on the information obtained from a sample of developers, it appears that for the few rental projects that have been developed recently in Vancouver, there are particular circumstances that allowed for a viable project but that might not be applicable on another site or for another developer.

As is the case in Toronto, land prices in the Vancouver CMA vary quite widely as illustrated in Table 20. The current land values for the City of Vancouver are considerably higher than the type of situation looked at here (in which the land was already held by the investor). This is a further indication that the viability of private rental construction in Vancouver at present is limited to a select number of sites and circumstances.

**Table 19**

## Proforma for Rental Apartment Construction Vancouver

*Per Unit*

**INITIAL INPUT ASSUMPTIONS**

| | | | |
|---|---|---|---|
| Mortgage interest rate | 6.00% | Cost inflation | 2% |
| Amortization period (yrs) | 25 | Rent inflation | 2% |
| Loan-to-lending value ratio | 80% | Initial monthly rent | $825 |
| Mortgage insur. premium | 3.0% | Vacancy rate | 3% |
| GST | 7% | | |

**PROJECT DEVELOPMENT COSTS AND FINANCING**

| **Development Costs:** | | **Financing:** | |
|---|---|---|---|
| Land | $30,000 | Equity | $52,318 |
| Construction | $80,000 | Mortgage | $65,382 |
| Subtotal | $110,000 | Total Costs | $117,700 |
| | | *% Equity* | *44.5%* |
| GST | $7,700 | Mortgage Insurance Premium | $1,961 |
| **Total Costs** | **$117,700** | **Total Financing Required** | **$67,344** |

**REVENUES AND COSTS**

| | **Year 1** | **Year 5** |
|---|---|---|
| **Revenues:** | | |
| Rental income | $9,900 | $10,716 |
| Other Income | $466 | $505 |
| Vacancy allowance | -$311 | -$337 |
| **Gross income** | **$10,055** | **$10,884** |
| **Operating Costs:** | | |
| Maintenance and operations | na | na |
| Property taxes | na | na |
| **Total operating costs** | **$2,700** | **$2,923** |
| **Net Operating Income** | **$7,355** | **$7,962** |
| *Initial value for lending purposes** | *$81,728* | |
| *Actual cap rate* | *6.2%* | |
| **Mortgage Payments:** | | |
| Principal | 1,212 | 1,535 |
| Interest | 3,958 | 3,635 |
| **Total** | **5,170** | **5,170** |
| *Initial debt coverage ratio* | *1.42* | |
| *Using 9% interest rate/35 yr. amort.*** | *1.18* | |
| **Cash Flow** | **2,185** | **2,791** |
| **Cash-on-Cash Return** | **4.2%** | **5.3%** |

* Based on 9% cap rate ** Must be minimum of 1.1 to meet CMHC criteria

**Table 20**

## Typical Land Purchase Prices Vancouver, 1997

| Municipality | Land Purchase Price<br>*$ per Unit* |
|---|---|
| Langley City | $12,158 |
| Langley Township | $12,158 |
| Maple Ridge | $12,158 |
| Pitt Meadows | $12,158 |
| Coquitlam 1 | $18,237 |
| Delta | $18,237 |
| Port Coquitlam | $18,237 |
| Port Moody | $18,237 |
| Surrey | $18,237 |
| New Westminster | $24,316 |
| White Rock | $24,316 |
| Richmond | $30,395 |
| Burnaby 2 | $42,553 |
| Vancouver 3 | $48,632 |
| North Vancouver City | $60,789 |
| North Vancouver District | $60,789 |

1 Excludes Westwood Plateau
2 Excludes Okalla Lands
3 Excludes Downtown & The Westside

Source: **A Compiliation of Land Costs in 16 Selected Lower Mainland Municipalities**, Prepared for Greater Vancouver Housing Corporation by Perry Steniscia, October 1997

### *A Note on Development Cost Charges*

In Vancouver and Toronto, development cost charges also factor into the economics of private rental construction. Table 21 and Table 22 illustrate the range of these charges in the Vancouver CMA and GTA. These charges are typically payable prior to the issuance of a building permit. For subdivision development, other charges may be payable (such as engineering fees, cash in lieu of parkland dedication, per acre charges for infrastructure etc.) in these municipalities as well as in those centres where the municipality rather than the developer is responsible for installing the services. These charges associated with land development are not examined here since they have typically already been paid by the land developer and are reflected in the sale price of a serviced block of land to an apartment builder. Very rarely does an apartment developer buy raw land solely for apartment development.

**Table 21**

## Development Cost Charges for 2-bedroom Apartment Units Toronto, $ Per Unit

| Regional Municipality | Local Municipality | Regional Development Charge | Municipal Development Charge | Education Development Charge | Public Utility Charge | Total |
|---|---|---|---|---|---|---|
| Durham | Ajax | 5,626 | 4,141 | 1,728 | 445 | 11,940 |
| Durham | Oshawa | 5,626 | 2,377 | 1,728 | 343 | 10,074 |
| Durham | Pickering | 5,626 | 3,735 | 1,728 | 660 | 11,749 |
| Durham | Whitby | 5,626 | 3,652 | 1,728 | 341 | 11,347 |
| York | Aurora | 4,637 | 4,053 | 2,350 | 430 | 11,470 |
| York | Markham | 4,637 | 4,188 * | 2,350 | 291 | 11,466 |
| York | Newmarket | 4,637 | 2,749 * | 2,350 | 100 | 9,836 |
| York | Richmond Hill | 4,637 | 4,080 * | 2,350 | 509 | 11,576 |
| York | Vaughan | 4,637 | 4,867 * | 2,350 | - | 11,854 |
| Peel | Brampton | 3,016 | 4,806 | 2,271 | 359 | 10,452 |
| Peel | Caledon | 3,016 | 4,846 * | 2,271 | - | 10,133 |
| Peel | Mississauga | 3,016 | 3,878 | 2,271 | 309 | 9,474 |
| Halton | Burlington | 3,027 | 4,712 * | 1,269 | 646 | 9,654 |
| Halton | Halton Hills | 3,027 | 3,371 * | 1,269 | 292 | 7,959 |
| Halton | Oakville | 3,027 | 4,027 | 1,269 | 496 | 8,819 |
| Metro Toronto | Etobicoke | - | 1,932 *,** | - | - | 1,932 |
| Metro Toronto | North York | - | 2,347 | - | 84 | 2,431 |
| Metro Toronto | Scarborough | - | 2,412 | - | 309 | 2,721 |
| Metro Toronto | Toronto | - | - | - | - | - |

Note: Assumes unit size of greater than 850 sq. ft.
* Additional area specific charges may apply
** Includes hydro charge
Source: Municipal Levies, Fees and Charges in the Greater Toronto Area, Prepared for the Greater Toronto Home Builders' Association by Greg Lampert and Dan Clement, January 1998

**Table 22**

## Development Cost Charges Vancouver, 1997

| Municipality | Regional Charge Per Unit ($) | Local Charge Per Unit ($) |
|---|---|---|
| Burnaby | 590 - 1,082 | 884 - 1,436 |
| Coquitlam | 1,082 | 7,560 |
| Delta | 1,082 | 2,958 - 9,567 |
| City of Langley | 1,082 | 7,498 |
| Langley Township | 1,082 | 9,373 - 13,406 |
| Maple Ridge | 1,082 | 5,438 - 13,083 * |
| New Westminster | 1,082 | 0 - 3,566 |
| City of North Vancouver | 807 | $4.58/sq. ft. GFA |
| North Vancouver District | 807 | 8,632 * |
| Pitt Meadows | 1,082 | 5,463 |
| Port Coquitlam | 1,082 | 4,379 - 15,115 |
| Port Moody | 1,082 | 3,360 - 4,450 |
| Richmond | 673 | 7,088 - 13,092 |
| Surrey | 1,082 | 11,950 |
| Vancouver | 1,082 | 0 - 6.18/sq. ft. GFA ** |
| White Road | 1,082 | 11,297 |

* Proposed as of October 1997
** In areas where development cost charges do not apply, community amenity contributions are expected from specific residential rezonings and typically total about $4.00/sq. ft.

Source: **A Compiliation of Land Costs in 16 Selected Lower Mainland Municipalities**, Prepared for Greater Vancouver Housing Corporation by Perry Steniscia, October 1997

To assess the actual impact of development charges on the economics of private rental construction, it must be recognized that when an apartment developer is considering the purchase of a site, the price that they are prepared to pay will typically be calculated residually taking into account all of the costs, revenues and return on investment. In theory, if two identical sites are located on either side of a road which forms a municipal boundary and on one side there is a $10,000 development charge and on the other there is no charge, the value of the site where the development charge is payable should be $10,000 less.

This theoretical example breaks down, however, where the site in the municipality where there is not a development charge is already valued at below $10,000. The example also does not take into account that there may be alternative uses that would achieve a higher value such as condominium apartments or townhouses. Although these uses would also incur development charges, they may still be more economically feasible to build than rental apartments and thus result in a higher residual land value even where a development charge applies.

One of the key problems with development charges, particularly in the GTA, is that the charges are often highest in the suburban municipalities where rents are relatively lower (than in the central city). The result is often that the residual land value is negative or lower than a vender is willing to accept given the alternatives of selling it for another use (even if it means rezoning). Often, apartment sites will sit idle in these municipalities as the developer awaits more favourable economic conditions rather than selling the property for a minimal price.

### *Halifax*

The proforma for Halifax (Table 23) is a composite based on the cost and income profiles of three projects which were actually built in recent years, with changes to certain assumptions to render the results consistent with the analysis for the other 5 centres.

The analysis confirms why there has been some new rental unit development in Halifax in recent years - the numbers can work. The proforma exercise shows a reasonable cash-on-cash return of just under 20% in the initial year. And it can be done with a relatively small amount of equity (20%). It should be noted, however, that the assumed vacancy rate of 3% is below the current rate on average in the Halifax market (5.5%).

What makes new rental unit development more feasible in Halifax than Toronto and Vancouver? Primarily, it is the lower project development costs (in spite of the higher 15% HST), but lower operating costs also play a role. While achievable rents are also somewhat lower in Halifax, the gap is not as pronounced as on the cost side.

### *Montreal*

The proforma for Montreal (Table 24) has been derived based on updates of previous work for CMHC by Clayton Research. The cost and income structure would be applicable to a small low-rise apartment building - typical of many of the projects built in the latter 1980s. Note that both the GST and the Quebec Sales Tax (QST) will apply to the land and construction costs.

Returns are low and, combined with the current softness in the Montreal rental market, do not make this a particularly attractive investment. The relatively low rents that would be achievable limit the net operating income; a substantial 35 percent equity would therefore be required.

Table 23

## Proforma for Rental Apartment Construction Halifax

*Per Unit*

**INITIAL INPUT ASSUMPTIONS**

| | | | |
|---|---|---|---|
| Mortgage interest rate | 6.00% | Cost inflation | 2% |
| Amortization period (yrs) | 25 | Rent inflation | 2% |
| Loan-to-lending value ratio | 80% | Initial monthly rent | $850 |
| Mortgage insur. premium | 3.0% | Vacancy rate | 3.0% |
| HST | 15% | | |

**PROJECT DEVELOPMENT COSTS AND FINANCING**

| **Development Costs:** | | **Financing:** | |
|---|---|---|---|
| Land | $10,500 | Equity | $15,640 |
| Construction | $57,500 | Mortgage | $62,560 * |
| Subtotal | $68,000 | Total Costs | $78,200 |
| | | *% Equity* | *20.0%* |
| HST | $10,200 | Mortgage Insurance Premium | $1,877 |
| **Total Costs** | **$78,200** | **Total Financing Required** | **$64,437** |

**REVENUES AND COSTS**

| | **Year 1** | **Year 5** |
|---|---|---|
| **Revenues:** | | |
| Rental income | $10,200 | $11,041 |
| Other Income | $481 | $520 |
| Vacancy allowance | -$320 | -$347 |
| **Gross income** | **$10,360** | **$11,214** |
| **Operating Costs:** | | |
| Maintenance and operations | $1,800 | $1,948 |
| Property taxes | $800 | $866 |
| **Total operating costs** | **$2,600** | **$2,814** |
| **Net Operating Income** | **$7,760** | **$8,400** |
| *Initial value for lending purposes** | *$86,225* | |
| *Actual cap rate* | *9.9%* | |
| **Mortgage Payments:** | | |
| Principal | 1,160 | 1,469 |
| Interest | 3,788 | 3,478 |
| **Total** | **4,947** | **4,947** |
| *Initial debt coverage ratio* | *1.57* | |
| *Using 9% interest rate/35 yr. amort.*** | *1.30* | |
| **Cash Flow** | **2,813** | **3,453** |
| **Cash-on-Cash Return** | **18.0%** | **22.1%** |

* Assumes a 9% cap rate; since lending value is greater than project costs, the loan-to-value ratio is applied to the actual project costs, not the lending value to determine mortgage

** Must be minimum of 1.1 to meet CMHC criteria

Table 24

## Proforma for Rental Apartment Construction Montreal

*Per Unit*

**INITIAL INPUT ASSUMPTIONS**

| | | | |
|---|---|---|---|
| Mortgage interest rate | 6.00% | Cost inflation | 2% |
| Amortization period (yrs) | 25 | Rent inflation | 2% |
| Loan-to-lending value ratio | 80% | Initial monthly rent | $450 |
| Mortgage insur. premium | 3.0% | Vacancy rate | 3.0% |
| GST/QST | 15.03% | | |

**PROJECT DEVELOPMENT COSTS AND FINANCING**

| **Development Costs:** | | **Financing:** | |
|---|---|---|---|
| Land | $8,000 | Equity | $19,255 |
| Construction | $40,500 | Mortgage | $36,532 |
| Subtotal | $48,500 | Total Costs | $55,787 |
| | | *% Equity* | *34.5%* |
| GST/QST | $7,287 | Mortgage Insurance Premium | $1,096 |
| **Total Costs** | **$55,787** | **Total Financing Required** | **$37,628** |

**REVENUES AND COSTS**

| | **Year 1** | **Year 5** |
|---|---|---|
| **Revenues:** | | |
| Rental income | $5,400 | $5,845 |
| Other Income | $254 | $275 |
| Vacancy allowance | -$170 | -$184 |
| **Gross income** | **$5,485** | **$5,937** |
| **Operating Costs:** | | |
| Maintenance and operations | na | na |
| Property taxes | na | na |
| **Total operating costs** | **$1,375** | **$1,488** |
| **Net Operating Income** | **$4,110** | **$4,449** |
| *Initial value for lending purposes** | *$45,665* | |
| *Cap rate* | *7.4%* | |
| **Mortgage Payments:** | | |
| Principal | 677 | 858 |
| Interest | 2,212 | 2,031 |
| **Total** | **2,889** | **2,889** |
| *Initial debt coverage ratio* | *1.42* | |
| *Using 9% interest rate/35 yr. amort.*** | *1.18* | |
| **Cash Flow** | **1,221** | **1,560** |
| **Cash-on-Cash Return** | **6.3%** | **8.1%** |

* Assumes a 9% cap rate ** Must be minimum of 1.1 to meet CMHC criteria

**Table 25**

## Proforma for Rental Apartment Construction Winnipeg

*Per Unit*

**INITIAL INPUT ASSUMPTIONS**

| | | | |
|---|---|---|---|
| Mortgage interest rate | 6.00% | Cost inflation | 2% |
| Amortization period (yrs) | 25 | Rent inflation | 2% |
| Loan-to-lending value ratio | 80% | Initial monthly rent | $700 |
| Mortgage insur. premium | 3.0% | Vacancy rate | 3.0% |
| GST | 7% | | |

**PROJECT DEVELOPMENT COSTS AND FINANCING**

| **Development Costs:** | | **Financing:** | |
|---|---|---|---|
| Land | $5,200 | Equity | $16,492 |
| Construction | $57,000 | Mortgage | $50,062 |
| Subtotal | $62,200 | Total Costs | $66,554 |
| | | *% Equity* | *24.8%* |
| GST | $4,354 | Mortgage Insurance Premium | $1,502 |
| **Total Costs** | **$66,554** | **Total Financing Required** | **$51,564** |

**REVENUES AND COSTS**

| | **Year 1** | **Year 5** |
|---|---|---|
| **Revenues:** | | |
| Rental income | $8,400 | $9,092 |
| Other Income | $396 | $428 |
| Vacancy allowance | -$264 | -$286 |
| **Gross income** | **$8,532** | **$9,235** |
| **Operating Costs:** | | |
| Maintenance and operations | na | na |
| Property taxes | na | na |
| **Total operating costs** | **$2,900** | **$3,139** |
| **Net Operating Income** | **$5,632** | **$6,096** |
| *Initial value for lending purposes** | *$62,577* | |
| *Cap rate* | *8.5%* | |
| **Mortgage Payments:** | | |
| Principal | 928 | 1,176 |
| Interest | 3,031 | 2,783 |
| **Total** | **3,959** | **3,959** |
| *Initial debt coverage ratio* | *1.42* | |
| *Using 9% interest rate/35 yr. amort.*** | *1.18* | |
| **Cash Flow** | **1,673** | **2,137** |
| **Cash-on-Cash Return** | **10.1%** | **13.0%** |

* Assumes a 9% cap rate ** Must be minimum of 1.1 to meet CMHC criteria

**Table 26**

## Proforma for Rental Apartment Construction Calgary

*Per Unit*

**INITIAL INPUT ASSUMPTIONS**

| | | | |
|---|---|---|---|
| Mortgage interest rate | 6.00% | Cost inflation | 2% |
| Amortization period (yrs) | 25 | Rent inflation | 2% |
| Loan-to-lending value ratio | 80% | Initial monthly rent | $875 |
| Mortgage insur. premium | 3.0% | Vacancy rate | 3.0% |
| GST | 7% | | |

**PROJECT DEVELOPMENT COSTS AND FINANCING**

| **Development Costs:** | | **Financing:** | |
|---|---|---|---|
| Land | $11,500 | Equity | $25,393 |
| Construction | $73,000 | Mortgage | $65,022 |
| Subtotal | $84,500 | Total Costs | $90,415 |
| | | *% Equity* | *28.1%* |
| GST | $5,915 | Mortgage Insurance Premium | $1,951 |
| **Total Costs** | **$90,415** | **Total Financing Required** | **$66,972** |

**REVENUES AND COSTS**

| | **Year 1** | **Year 5** |
|---|---|---|
| **Revenues:** | | |
| Rental income | $10,500 | $11,366 |
| Other Income | $495 | $536 |
| Vacancy allowance | -$330 | -$357 |
| **Gross income** | **$10,665** | **$11,544** |
| **Operating Costs:** | | |
| Maintenance and operations | na | na |
| Property taxes | na | na |
| **Total operating costs** | **$3,350** | **$3,626** |
| **Net Operating Income** | **$7,315** | **$7,918** |
| *Initial value for lending purposes** | *$81,277* | |
| *Actual cap rate* | *8.1%* | |
| **Mortgage Payments:** | | |
| Principal | 1,205 | 1,527 |
| Interest | 3,937 | 3,615 |
| **Total** | **5,142** | **5,142** |
| *Initial debt coverage ratio* | *1.42* | |
| *Using 9% interest rate/35 yr. amort.*** | *1.18* | |
| **Cash Flow** | **2,173** | **2,776** |
| **Cash-on-Cash Return** | **8.6%** | **10.9%** |

* Assumes a 9% cap rate ** Must be minimum of 1.1 to meet CMHC criteria

### *Winnipeg*

The proforma for Winnipeg (Table 25) has been derived based on updates of previous work undertaken for CMHC by Clayton Research. The cost and income structure would be applicable to a mid-sized (about 50 unit) walk-up apartment building - typical of many of the projects built in the latter 1980s.

The project generates an initial cash-on-cash return of about 10 percent - above that of some other centres, but still relatively moderate. However, the current high vacancy rates in the Winnipeg market would likely make the assumed 3 percent vacancy rate difficult to achieve at the assumed rents.

### *Calgary*

The proforma for Calgary (Table 26) has been derived based on updates of previous work undertaken for CMHC by Clayton Research. The cost and income structure would be applicable to a mid-sized (about 30 unit) walk-up apartment building.

The current economics of the project are not particularly attractive i.e. generating a cash-on-cash return of less than 10%.

However, this type of project would become more attractive as rents rise further. As discussed earlier, the tight rental market that has recently evolved in Calgary has just started to have a positive impact on achievable rents - additional increases in rents in general will still be forthcoming.

### *Comparison Among the 6 Selected Markets*

A comparison of the relative economics of new private rental unit development is summarized on Table 27.

For most centres (the exception being Halifax), the potential cash-on-cash returns are well below the 15% that developers in general are looking for.

Note that while investors in most centres expressed concerns on high property taxes, the proforma analysis suggests that in reality this has been more of an issue in Toronto than the other 5 centres. And it has become less of an issue in Toronto with the recent changes in Ontario in the potential property tax treatment of new rental buildings.

### *Comparison with Returns on Existing Rental Buildings*

Not only are returns on new development typically below the 15% that developers are seeking, but they are in general also not attractive in relation to returns on existing investment (Figure 78).

The potential returns in most cases are below those that can be achieved on existing rental properties. The exception is Calgary, where returns between new and existing investment are comparable, but modest. The most pronounced gaps between investment in new and existing rental buildings are for Toronto and Montreal.

**Table 27**

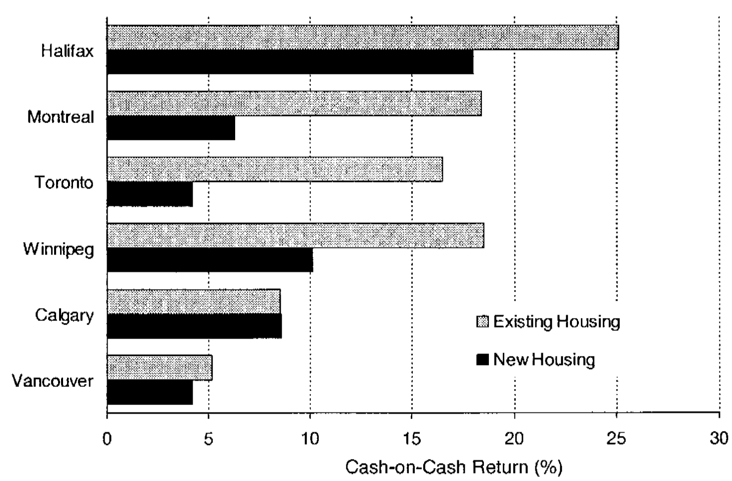
**The Economics of New Private Rental Housing Development**
**Selected Major Markets**

| | Halifax | Montreal | Toronto | Winnipeg | Calgary | Vancouver |
|---|---|---|---|---|---|---|
| **Key Input Assumptions:** | | | | | | |
| Average Project Development Costs Per Unit | $78,200 | $55,787 | $129,470 | $66,554 | $90,415 | $117,700 |
| Net Annual Operating Income | $7,760 | $4,110 | $8,148 | $5,632 | $7,315 | $7,355 |
| *Ratio of Operating Costs to Gross Income* | *25.1%* | *25.1%* | *36.3%* | *34.0%* | *31.4%* | *26.9%* |
| Value for Lending Purposes* | $86,225 | $45,665 | $90,532 | $62,577 | $81,277 | $81,728 |
| Financing Assumptions: | | | | | | |
| Required Equity | $15,640 | $19,255 | $57,044 | $16,492 | $25,393 | $52,318 |
| Equity Ratio** | 20.0% | 34.5% | 44.1% | 24.8% | 28.1% | 44.5% |
| Amortization Period (Years) | 25 | 25 | 25 | 25 | 25 | 25 |
| Interest Rate | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| CMHC Insured | Yes | Yes | Yes | Yes | Yes | Yes |
| CMHC Premium | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% |
| **Financial Performance (Year 1):** | | | | | | |
| Cap Rate | 9.9% | 7.4% | 6.3% | 8.5% | 8.1% | 6.2% |
| Cash Flow | $2,813 | $1,221 | $2,420 | $1,673 | $2,173 | $2,185 |
| Cash-on-Cash Return | 18.0% | 6.3% | 4.2% | 10.1% | 8.6% | 4.2% |

* Using a 9% cap rate ** Relative to total project development costs
Source: Table 23, Table 24, Table 17, Table 25, Table 26, Table 19

**Figure 78**

**Comparison of Potential Returns on New and Existing Rental Housing, Selected Major Markets**




Source: Table 14 and Table 27

## Focus on Investment in New Private Rental Housing - Summary of Key Findings

- As with investors in existing housing, investors in new rental housing perceive the main advantages relative to other types of real estate as being stable cash flow, less risk and lower vacancies.
- The main disadvantages are perceived as the extent of government intervention and high property taxes.
- The key factor in the decision-making process for investors in new rental buildings is the economic viability of a project, followed by its location.
- There appears to be increased interest in developing new rental units. However, the poor economics of new rental unit development remains a stumbling block.
- For the 6 major markets examined in this study (Halifax, Montreal, Toronto, Winnipeg, Calgary and Vancouver), the potential cash-on-cash returns for new rental unit development are generally well below the minimum 15% that developers typically are looking for.
- As well, returns on new development are not attractive in relation to returns on existing investment, particularly in Toronto and Montreal.

# CHAPTER 6 - FUTURE PROSPECTS AND IMPLICATIONS FOR KEY PLAYERS

This chapter examines the future prospects for investment in private rental housing in Canada and the implications for key players - including investors, developers, lenders, mortgage insurers and government.

The chapter first looks at the prospects for rental investment in general, and then in the six major markets selected for special attention in this study. This is followed by a more general discussion of the opportunities for rental investment, and the challenges that will be faced for the key players in rental investment. Then, suggestions for dealing with the challenges are examined.

## Future Prospects for Rental Investment

This section focuses on the future prospects for rental investment.

### The Inherent Attractiveness of Rental Investment Will Continue

As was evident in the profile of rental investors developed in Chapters 4 and 5, there are many facets of rental investment which make it attractive to investors relative to other types of real estate. Key among these are:

- The stable income flow;
- The lower risk (as indicated by, in general, the relatively low and less volatile vacancies);
- The many, diverse tenants - which also reduces the risk of vacancy;
- Easier to manage/less complex to understand; and
- The ever-present need for housing.

Less prevalent, but important for some investors, are other aspects such as:

- The availability of financing at favourable rates and, with CMHC insurance, the high leverage opportunity;
- The potential for capital gains;
- For investors in existing housing, the fact that unit costs are well below replacement costs; and
- The benefits of portfolio diversification.

These factors that make rental investment attractive are largely inherent - as such, all other things being equal, **potential** investor interest in rental properties will continue in the future.

### Will the Current Detractions Also Persist?

But, as examined in Chapters 4 and 5, there are also aspects of rental investment that detract from it. Key among these are:

- The current state of (dis)repair of the existing stock, and the concerns that massive future investment in capital upgrades will be required;
- The extent of government intervention - and the fact that the "rules" are constantly changing; and
- High property taxes.

These aspects of rental housing are not inherent to it, but rather are generally a result of policy decisions. As such, their future role is more difficult to predict. Given the current situation, however, they are expected to persist as factors which will detract from the attractiveness of rental investment.

### The Demand for Rental Housing Will Be Growing

Projections by CMHC suggest that demographic factors over the next 20 years will generate a need for roughly 50,000-60,000 additional rental units to be created in Canada each year (Figure 79) - even without allowing for replacement of any units lost from within the existing stock (through demolitions, conversions to ownership, etc.).

This is well above the 37,000 units created per year on average in the first half of the 1990s.

This is good news for investors in the existing rental stock, as it suggests that there will continue to be a "need" for their rental units.

It also suggests that, from a demand perspective, there will be increasing opportunities for new rental units to be created, either from within the existing rental stock (i.e. through conversions) or from new rental unit development.

### So Too the Need for Upkeep and Upgrades to the Existing Rental Stock

In addition, there will be the need for investment in maintaining and revitalizing the existing rental stock. Comprehensive estimates of the extent of deferred maintenance are not available. However, in the interviews with investors conducted for this study, the perception was that the rental stock is not being maintained to the same degree as ownership housing.

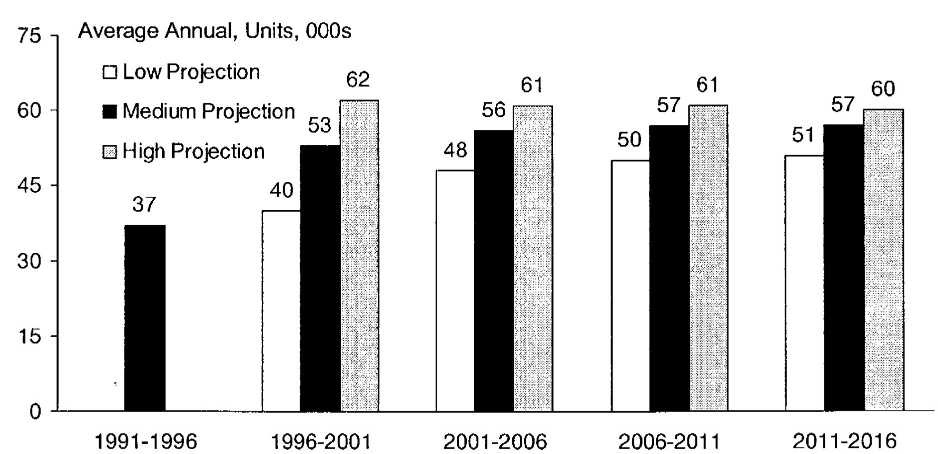
The relative aging of the stock also suggests that average repair and renovation spending will be increasing. In 1996, about one-third of the rental stock was at least 35 years old i.e. built before 1961 (Figure 80); in 10 years, the proportion at least 35 years old will have risen to one-half. And recall that average spending is higher on older units (refer back to Figure 31).

While the need for renovations of the rental stock is a "challenge" to the owners of the stock (who must finance the work), it does represent an "opportunity" for those involved in renovation work and lending.

The new Tenant Protection Act in Ontario is expected to give an added boost to "non-essential" renovation work on private rental buildings. Many landlords are already looking to "reposition" their units to attract higher income renters - and therefore achieve higher rents - by undertaking substantial upgrades.

**Figure 1**

**Need for Additional Rental Housing Units***
**Canada, 1996-2016**

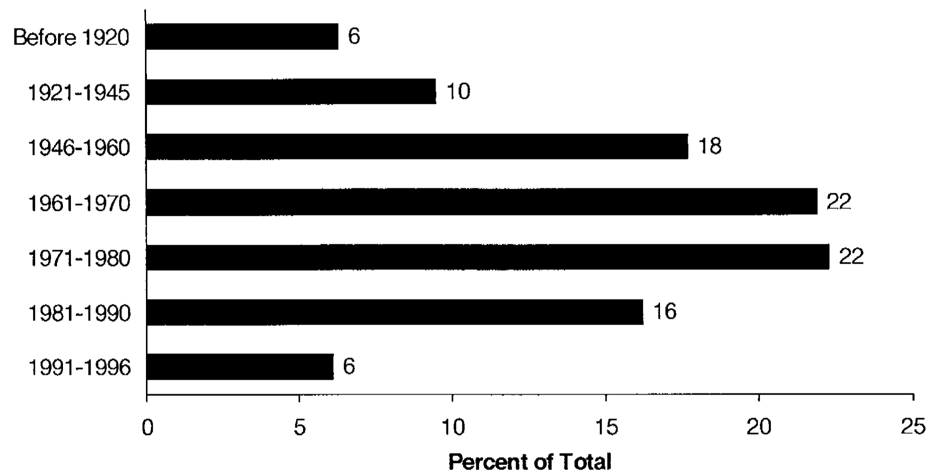



* As approximated by renter household growth. Includes both private and assisted units and all structural types

Source: Clayton Research based on Census of Canada data and projections by CMHC

Figure 80

**Occupied Rental Units by Period Constructed**
**Canada, 1996**




Source: Clayton Research based on Census of Canada data

## Relative Prospects for Rental Investment in Selected Major Markets

This section examines the relative prospects for higher levels of new rental unit development and repair and renovation work for the 6 major markets selected for special analysis in this study over the short to medium-term (i.e. next 5 years).

### *New Rental Unit Development*

The prospects for higher levels of new rental unit investment over the next 5 years relative to recent years are highest for Calgary and Toronto.

In **Calgary**, the dramatic decline in the rental vacancy rate in recent years, and the return of real rent increases (refer back to Figure 39), have started to improve the economics of new rental construction. While as yet returns are still not particularly attractive (refer back to Table 27), further increases in rents are likely to emerge, which will lead to additional improvements, and eventually new construction.

As shown in Chapter 4 (Table 18), the economics of new rental development in **Toronto** are still relatively poor. However, the new Ontario Tenant Protection Act, as well as the potential for reduced property taxes based on the Fair Municipal Finance Act, have increased interest in developing new rental properties. As rents in general start to rise over the next few years, and provided municipalities in the Toronto area act on reducing property taxes for rental buildings, the economics will start to improve. However, substantive rent increases and/or other improvements to the economics of new rental construction will likely be necessary before any significant amounts of new activity would start to emerge.

In **Vancouver**, the continued poor economics of new rental unit development (refer back to Table 27), combined with the current economic downturn, suggest that it may be several years before higher levels of new rental unit development will occur.

In **Montreal**, **Winnipeg** and **Halifax,** the persistent oversupply will need to be worked down much more substantially before any substantial increase occurs in new rental unit development.

***Repair and Renovation Work***

The broad patterns of repair and renovation work are expected to be similar to those of new rental unit development. To the extent that the Calgary and Toronto markets are expected to exhibit stronger rent increases than the other four centres in the next few years, the potential returns to investment in upgrading will make higher renovation activity more feasible in these two markets. Also, as indicated, repositioning efforts on the parts of some landlords in the Toronto area will provide an added boost in this market.

## Opportunities and Challenges for Key Players

This section explores the opportunities and challenges faced by key players in private rental investment. The assessment is based on the situation prevailing today - changes in policies, etc. which might help deal with the challenges are explored in the next section.

### Investors in Existing Housing

***The Opportunities***

As shown previously, demand for rental housing over the next 20 years is expected to grow by roughly 50,000 units a year. This buoyant demand means that the oversupply currently exhibited in most markets will be gradually worked down - which bodes well for future real rent increases, and, other things being equal, higher returns.

Current owners of existing housing may also benefit from the fact that the supply of "distressed" properties has been worked down in most markets. Competition among those investor groups who have indicated strong expansion plans (such as the REITs and real estate companies) could act to bid up values of existing properties.

***The Challenges***

A key challenge for investors in the existing housing stock is the current state of repair. It is expected that increasingly higher levels of investment will be needed to keep the stock from deteriorating, particularly as it continues to age in relative terms. This will increase both operating expenses and, if funds are borrowed, the amount of debt payments - which will temper the returns that might otherwise be achieved as rents rise.

Another key challenge is the extent of government intervention in the rental sector - either directly, through rent control/review schemes and landlord/tenant legislation, or indirectly through government imposed costs. In particular, changing rules and swings - often back and forth - in policies by successive governments have created a climate of uncertainty for investors in existing rental housing.

### Developers/Builders of New Purpose-Built Rental Housing

***The Opportunities***

The relatively more buoyant rental demand levels expected over the next 20 years compared to the 1990s thus far suggests that there will be a substantial need for additional rental units to be built, particularly once excess vacancies in the existing stock are worked down.

And in Ontario, recent actions by the province, such as exemption of new units from rent increase ceilings indefinitely, and the potential for property taxes in the future to be more in line with ownership housing, have further enhanced interest in new construction.

As well, there appears to be a growing interest in new buildings among investors who have previously focused on the existing market (e.g. pensions funds, REITs). There may, therefore, also be emerging opportunities for developers to build properties for sale to other investors, rather than for retention in their own portfolios.

*The Challenges*

The key, and substantial, challenge for this group will be overcoming the current poor economics of new purpose-built rental unit development, as discussed in Chapter 5. Despite the favourable changes that have occurred in some markets, such as Toronto, achievable market rents in most cases still do not justify the costs of new development.

In addition, while interest rates are favourable for financing new investment at present, the uncertainty of future interest rate trends, and the potential for reduced cash flow if rates were to rise substantially, still makes investment in this sector precarious.

**Renovators**

*The Opportunities*

As already discussed, the need for maintaining and revitalizing the existing rental stock will be growing over the next 20 years. At the same time, the stock will be growing - and with it, growth in the number of units that will require some work.

In addition, the opportunity for higher rents presented by the new Tenant Protection Act in Ontario is expected to lead some landlords to undertake substantive upgrading of units in order to reposition them in the market.

Depending on the actual strength of demand for additional rental units, and the proportion that can be accommodated by new purpose-built rental housing, renovators may also face opportunities in converting single-family homes to multiple rental suites, or in adding accessory suites/apartments in an investor's principle residence.

*The Challenges*

While the potential for higher levels of rental repair and renovation work is there, whether it will be realized is not certain. Rather, it depends in large part on the extent to which investors feel that they can achieve a return on their investment in upgrading their units. It will also depend on the extent to which additional public funding may be made available to deal with the problems of a deteriorating stock.

**Lenders and Mortgage Insurers**

*The Opportunities*

To the extent that the economics of new rental development improve in specific markets, and somewhat higher levels of investment start to emerge, there will be more opportunities to finance and insure new rental projects.

The potential growth in investment in upgrading the rental stock will provide additional business for lenders and mortgage insurers.

*The Challenges*

The amount of lending and insuring that takes place will follow the cyclical pattern normally evident in real estate. In the existing market, lenders and insurers, therefore, can likely expect some decline from the recent relatively buoyant levels of activity in general, although demand from certain types of investors who have announced strong acquisition plans (such as the public real estate companies and REITs) is likely to continue to increase.

Discussions with investors indicate that for CMHC, there is the added challenge of competing with conventional funding for existing properties, at least among that group of investors who are unhappy with what they perceive to be burdensome approval criteria and an onerous process. As well, CMHC may miss out on opportunities to insure new rental development in those cases where the proponent finds the CMHC criteria/process unfavourable and decides not to proceed at all with the project.

#### Government

*The Opportunities*

To the extent that higher levels of new rental development and upgrading of the existing rental stock occur, governments at all levels will benefit financially from revenues derived from associated direct and indirect taxes and from the increase in employment that will occur.

*The Challenges*

From a policy perspective, governments have a stake in ensuring an adequate, and well-maintained, supply of rental housing.

One of the main challenges for government will be to ensure that any government-originated costs to rental investment, particularly in developing new rental units, are fair and do not represent an undue burden.

If investment in upgrading the existing stock is not initiated by private investors because it is not justified by expected returns to this investment, governments face the challenge of considering alternatives (such as enhanced programs/subsidies) to encourage the necessary repairs and renovations.

## Facing the Challenges

As part of the interviews conducted for this study, investors and lenders were asked for their suggestions as to how the challenges faced by rental investors (as identified earlier in this chapter) might be overcome. The key suggestions offered are summarized below:[14]

### Challenge #1: Improving the Economics of New Rental Unit Development

In general, potential investors in new rental housing indicated that they are not looking for "handouts" in the form of subsidy programs or a return to favourable tax treatment (although there were some who held the opposite opinion). Most often, suggestions for meeting the challenge of the poor economics of new rental investment were aimed at removing what are perceived as current "roadblocks" or inequitable treatment. The most common specific suggestions included:

- Lowering project development costs by reducing the extent of government-imposed costs, such as development charges, lengthy approvals processes, overly stringent building code requirements, etc.;

[14] It should be emphasized that these are the main suggestions which were offered by investors and lenders; as such they do not represent a comprehensive list of all potential actions, nor should they be interpreted as the recommendations of the authors. An assessment of the feasibility and desirability of implementing the suggestions from a broader policy/societal perspective was not part of the mandate of the current study.

- Putting new rental housing on par with new ownership housing in terms of rebates for the GST/QST/HST, and property tax assessment; and
- Encouraging the federal government to pursue policies which promote a healthy economy (which are favourable for demand) and a low interest rate environment (which is favourable for costs of financing and cash flow).

**Challenge #2: The Extent of Government Intervention and Uncertainty Re: Future Policy Shifts**

Suggestions for dealing with this challenge were largely in the vein of simply reducing the amount of "hands-on" direct government intervention in the rental sector, in particular in terms of rent control/review schemes and landlord tenant legislation - and by doing so, also eliminating the uncertainties associated with constant policy swings between successive governments.

The prevailing sentiment among investors in this respect can be summed up by the phrase "let the market operate".

**Challenge #3: Maintaining/Upgrading the Existing Stock**

The main suggestion for meeting this challenge was to remove any artificial barriers to rent increases where they still exist and therefore improve the potential returns to investors for maintaining the condition of the stock.

**Challenge #4: Overcoming the Negative Perception Among Some Investors About the CMHC Mortgage Insurance Product/Process**

There were several key suggestions in this area:
- Speed up the process so that the turnaround time from application to approval is reduced;
- Introduce premiums and criteria which recognize the risk differentials among different applicants based on their past track record and different local market circumstances; and
- Use actual mortgage rates to determine debt-coverage ratios and market determined capitalization rates to determine lending values, rather than a 9% rate (since the interviews were conducted, CMHC has announced both these changes for existing properties).

## Seizing The Opportunities

The suggestions offered by investors and lenders for meeting the challenges of rental investment (and thereby enhancing its attractiveness and financial returns) outlined above typically sought changes in circumstances beyond their direct control.

What was not forthcoming in most cases, however, were direct suggestions as to changes that the investors themselves might effect to enhance the returns they can achieve from rental investment.

It was apparent from our discussions with investors, however, that some (albeit it appears the minority) are being proactive in this respect - that is, they are actively looking for ways of either reducing controllable costs, or increasing revenues, in order to improve their returns.

Some examples include:

- **Repositioning units to achieve higher rents**: as discussed earlier, some investors, particularly in the Toronto area, are assessing the potential paybacks/higher rents that would be achievable by upgrading their units to attract higher income renters.

- **Reducing controllable costs:** while some operating costs such as property taxes are not within the control of the investor, others such as maintenance and administration are. Some investors are investigating ways that they could reduce their controllable costs. These range from adopting new technologies to achieving economies of scale by growing their own portfolio, or merging with smaller investors/companies.
- **Public/private partnerships**: at least one developer was investigating a partnership with a municipality to develop rental housing on municipally owned land.
- **Spreading the risk:** the emergence of REITs and public real estate companies from previous privately owned companies has not only allowed for additional capital inflow to aid expansion plans, but also enhanced the attractiveness by spreading the risk among a larger number of investors.

## Future Prospects and Implications for Key Players - Summary of Key Findings

- CMHC projections indicate that the underlying demand for additional rental units will be growing over the next 20 years. Higher levels of renovation work are also expected to be needed, in response to an aging rental stock, and desirable renovations sought by some investors seeking to reposition their units to be more attractive to higher income renters.
- Given lower vacancy rates, and the potential for higher rents, opportunities for new rental development, as well as higher levels of repair and renovation work, are expected to emerge sooner in Calgary and Toronto than Halifax, Montreal, Winnipeg or Vancouver. However, in Toronto, new construction is expected to remain relatively limited unless the economics of new development can be enhanced further.
- Investors, developers, lenders, mortgage insurers and governments will each face their own challenges and opportunities in the rental sector, as discussed in this chapter.

# CHAPTER 7 - DIRECTIONS FOR FUTURE RESEARCH

This chapter explores potential future research initiatives that could further enhance the understanding of private rental investment in Canada.

## Assess the Overall Feasibility of Investor Suggestions for Enhancing Rental Investment

As indicated in Chapter 6, the suggestions for enhancing rental investment are based on discussions with investors and lenders, and reflect what they perceive to be necessary to meet the challenges of rental investment. Adopting these suggestions, however, while they would act in the favour of the investor, may or may not be desirable in a broader policy, fiscal or societal viewpoint. Additional broad-based analysis of these suggestions would be necessary to determine their overall feasibility.

## Explore the Feasibility of Undertaking A Comprehensive Survey of Rental Investors

The interviews with investors, developers, lenders and other key players in private rental investment conducted for this study have helped to provide insight for developing a preliminary profile of rental investors.

However, our understanding could be enriched by a more comprehensive survey of investors. Such a survey could help to fill existing data gaps, in particular with respect to the profile of investors and their characteristics, as well as the levels of returns being achieved.

A model for such a survey is provided by two surveys conducted in the U.S.

The first is the U.S. Bureau of the Census 1991 **Survey of Residential Finance;** the second is the U.S. Bureau of the Census Property Owners and Managers Survey. Between them, these two surveys collected a range of information on who owns the rental stock, their characteristics, how they are financing rental investment, operating costs and expenses, etc.

The feasibility of undertaking a single survey which covers the range of information provided on the U.S. surveys could be undertaken to determine the potential for obtaining comparable Canadian information.

## Explore the Feasibility of Expanding Information Collected from Other Sources

Rather than an independent survey, it may also be worthwhile to explore the possibility of using already existing vehicles for information collection.

For example, one vehicle which CMHC already has in place for collecting information from rental investors is its mortgage insurance application forms for rental housing. Consideration could be given to exploring the feasibility of expanding/refining the information collected to include additional information on the investor.

Of course, it would be important that any additional information collected not put any substantial extra unnecessary burden on the applicant. As discussed in Chapter 6 CMHC already faces the challenge of dealing with the perception among some investors that the application process is somewhat burdensome.

## Conduct Periodic Updates/Reviews

Factors which impact rental investment are changing rapidly. Even during the course of the research for this study, many changes occurred (such as in government policy and rental market conditions) which have impacted on the attractiveness of rental investment. It would be useful therefore to conduct periodic follow-ups to this study to deal with any future changes in the environment for rental housing investment.

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