HOUSING MARKET INFORMATION

HOUSING MARKET INSIGHT
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Determining factors in the profitability of rental condominiums in downtown Montréal

"Half of the condominiums show positive cash flows in downtown Montréal and Griffintown. On average, the calculations gave a gross operating return corresponding to nearly 1% of the initial investment, that is, the down payment."

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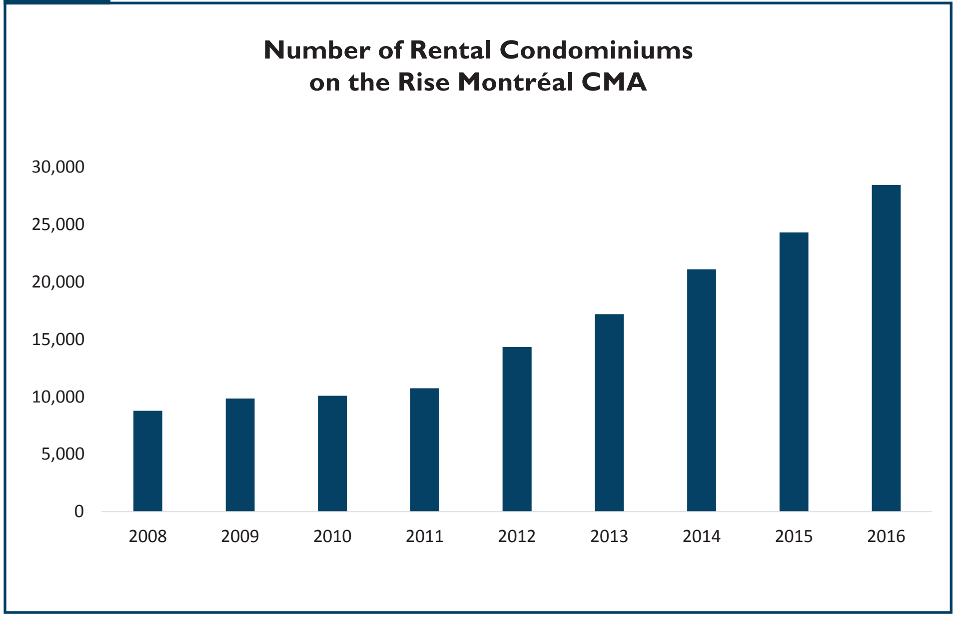
A growing phenomenon in the metropolitan area, rental condominiums have now reached a record proportion. As a result of significant construction and buyers' market conditions for several years, many unsold condominiums have ended up on the rental market. That said, an increasingly greater share of condominiums are purchased and then put up for rent by investors. With many new condominium and apartment projects about to be added to the rental market in Ville-Marie and Griffintown, it is worth looking into the profitability of this type of investment and the trends on the rental condominium market in these sectors.

This report provides aggregate data on gross operating cash flows related of rental condominiums and outlines certain aspects of the market dynamics in downtown Montréal.

For several years now, condominium rentals in the Montréal metropolitan area have posted unprecedented growth. Between 2010 and 2016, the total supply of rental condominiums rose at an average annual rate of 20%[1]. In some sectors, condominiums are now providing increased competition for the conventional rental market[2]. Currently, 16% of all condominiums are rental units in the Montréal census metropolitan area (CMA), compared to 9.4% in 2010. Downtown, one in four condominiums is a rental, which represents more than 5,700 units[3]. Figure 1 shows this trend in the Montréal CMA.

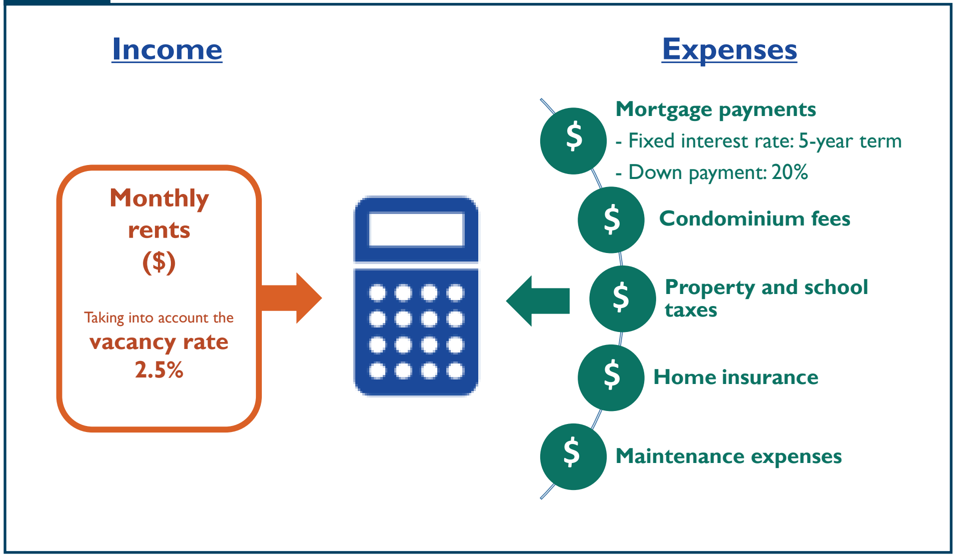
While, for some owners and developers, renting their condominiums is more of a temporary measure when they cannot sell quickly enough or at all, for others, the decision to rent would seem to be motivated by a desire to invest. The clear upward trend in this practice has brought us to take a closer look at rental condominiums from an investment standpoint. The objective of this publication is therefore to study the gross cash flows for this type of investment in Ville-Marie and Griffintown, in view of identifying the parameters that can have an impact on profitability. In that regard, we will also examine the dynamics of the condominium market in downtown Montréal.

Figure 1



Source: Rental Market Survey, October 2016, CMHC

Figure 2



Source: Centris®, City of Montréal (property assessment roll), Data compilation and calculations from CMHC

Methodology

For the purposes of this analysis, nearly 200 units were selected, exclusively in downtown Montréal and Griffintown[4]. The rent distribution in this sample was similar to that in the rental condominium stock in this sector.

The cash flows are composed of the rental income (inflows) and the expenses (outflows) related to the operation of the condominiums.

The income was calculated using the rents charged[5] and taking into account the vacancy rate for rental condominiums in downtown Montréal in 2016, that is, 2.5%[6]. As for the operating expenses[7] of the rental condominiums, they include:

1. mortgage payments;
2. condominium fees[8];
3. school taxes[9];
4. property taxes[10];
5. owner's home insurance[11]; and
6. property maintenance expenses[12].

For the mortgage payments, which were calculated using the purchase price of each of the properties studied, we went with the assumptions of a 20% down payment and a five-year fixed mortgage interest rate[13].

In order to avoid significant generalizations, it was decided that this study would cover only gross operating cash flows at the end of one year and would not take into account property acquisition costs or taxation at the end of the year.

Results: half of the condominiums show positive cash flows

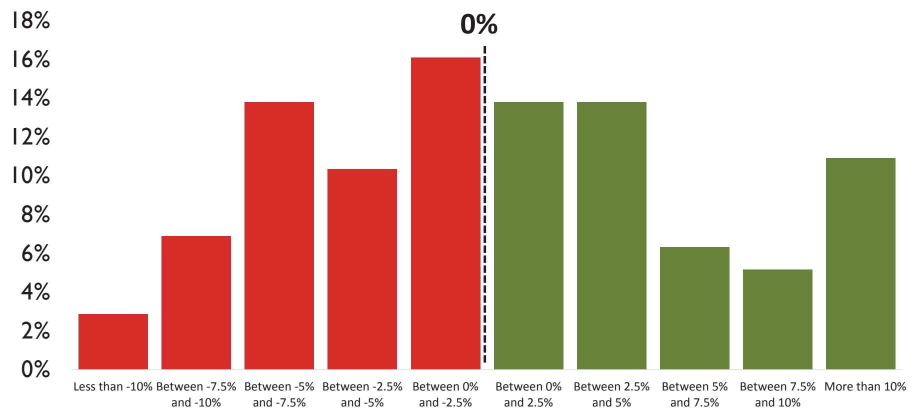
The application of the methodology outlined above to the downtown market in 2016 showed positive cash flows, on average. About 50% of the condominiums selected had cash flows above zero at the end of one year of operation. On average, the calculations gave a gross operating return (excluding taxes[14]) corresponding to nearly 1% of the initial investment, that is, the down payment.

An analysis of the distribution of the results revealed a wide range of results, however. While some condominium owners posted cash flows above 10% of the down payment, others sustained gross losses of less than 10%. That said, most condominium owners, that is, 54%, showed gross operating returns between -5% and 5% (see figure 3).

As well, a review of the results suggested that the returns varied with the price ranges[15]. In general, it was noted that, in the lower price ranges, the returns were slightly higher than in the other ranges[16]. In fact, in the case of the lower-priced units, the rents were higher as a proportion of the property values. In other words, the condominium owners likely had more flexibility with regard to the rents charged.

Figure 3

Percentage Distribution of Gross Returns on Down Payment
Gross Operating Cash Flows of Rental Condominiums



Source: Centris® system, City of Montréal (property assessment roll), Data compilation and calculations from CMHC

Table 1

Scenario Analysis: Changes in Vacancy Rate

Vacancy rate	1%	2.5%	3.5%	4.5%	6%
Average gross operating return	1.5%	0.9%	0.6%	0.2%	-0.4%
Share of condominium owners with a cash flow above 0	55%	51%	50%	46%	43%

Source: Rental Market Survey, October 2016, CMHC, Data compilation and calculations from CMHC

It is important to take into account the sensitivity of these results to several factors related to renting a dwelling, including the overall vacancy rate. In this study, this rate was estimated at 2.5%, reflecting the market conditions for all rent ranges in downtown Montréal in October 2016. The results can still vary, if the vacancy rate is raised or lowered (see table 1).

In addition, this analysis highlighted that condominiums with gross cash flows corresponding to more than 10% of the initial down payment all had something in common: the time of their purchase in the real estate cycle. In fact, practically of them were acquired in the late 1990s or early 2000s, that is, at the beginning of the upward cycle in house prices. In 2000, condominiums in downtown Montréal were selling for an average of $193,500, or 53% less than the average price in 2016. That said, it is probable that many of the owners of these units refinanced them to maximize leverage.

All in all, the time of purchase in the real estate cycle therefore appears to have a significant impact on the cash flows of rental condominiums.

In light of these results, it would seem that most investors in the sample studied were close to the break-even point at the end of one year of operation. It can therefore be concluded that the profitability of such investments will depend more on the gain in the value of homes at the time of resale.

Like for any other investment, buyers must exercise due diligence and perform a comprehensive analysis of all factors that could have an impact on the profitability of the property. In this regard, it is imperative to have a good understanding of the dynamics of the market in which the condominium exists and to consider the potential risks that could affect this market.

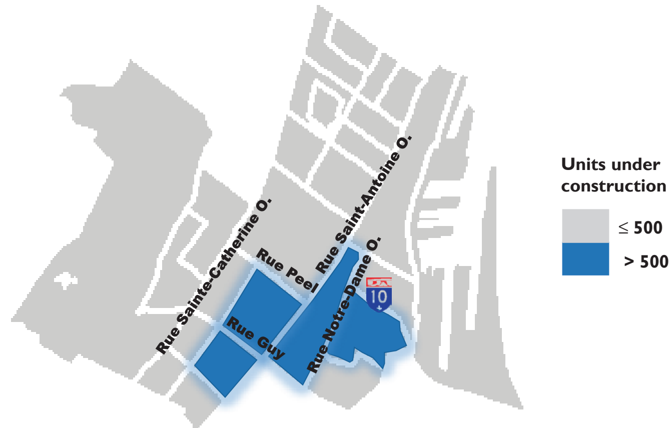
Potential risks on the downtown condominium market

While condominium starts in Ville-Marie are currently slowing down from the peak recorded in 2014, construction in this sector is still strong. There are now 4,078 condominiums[17] under construction in Ville-Marie and Griffintown. And, it can be noted that they are heavily concentrated in certain downtown sectors (see figure 4).

With, on average, one in three recent condominiums[18] ending up on the rental market, it can be expected that about 1,250 units will be up for rent upon completion. Compared to the current supply of rental condominiums, this represents a 20% increase that will be added to the downtown market over the coming quarters. It could therefore be anticipated that this increase will have certain impacts on the rental market and the resale market.

Figure 4

Condominium Construction Heavily Concentrated in Certain Downtown Sectors and Griffintown



Source: Condominium inventory under construction, February 2017, CMHC

Table 2

Rental Housing Units Under Construction in Downtown Montréal and Griffintown February 2017	
Rental apartments under construction	1,447
Condominiums potentially for rent under construction	1,248
Total potential rental housing units under construction	2,695

Source: Condominium inventory under construction, February 2017, CMHC calculations

Vacancy rate for rental condominiums in downtown Montréal could rise

While many rental condominiums will soon be added to the market, several conventional rental housing projects are also currently under construction downtown and in Griffintown. Given their rent levels and the services offered in these buildings, newer rental apartments and rental condominiums are proving to be real substitutes on the market. As a result, even with the strong demand for modern units downtown, the upcoming significant increase in supply could exceed demand in the short term, which could push up the vacancy rate on the rental condominium market. In this regard, the cash flows of some condominium owners having opted to rent their units could be adversely affected.

Market conditions for condominiums in downtown Montréal could remain favourable to buyers

Even though condominium sales jumped up by 21% in 2016 and led to significantly tighter market conditions in downtown Montréal[19] (excluding Griffintown), there are still currently 13 condominium listings per buyer on the market[20]. Given the large number of units under construction, it can be expected that some of the soon-to-be-completed units will end up on the resale market. It is therefore possible that the number of listings will rise, keeping condominium market conditions favourable to buyers. With less pressure on prices, there could be an impact on the gain in the value of condominiums at the time of resale, in the short term.

All in all, there are many parameters that can affect the gross operating cash flows and, by the same token, the profitability of rental condominiums: vacancy rate, price range of the condominium, time of purchase in the real estate cycle, to name but a few. It should also be noted that the state of the condominium rental market and the market conditions at the time of resale will have determining effects on the appreciation of the property value at a given period.

ENDNOTES

1 Source: CMHC (average growth in the supply of rental condominium apartments between 2010 and 2016).

2 Here, we have excluded the seniors' housing market.

3 Source: CMHC (Secondary Rental Market Survey), https://www03.cmhc-schl.gc.ca/catalog/productDetail.cfm?lang=en&cat=94&itm=3&fr=1490643167285.

4 To maximize the representativeness of the rental condominium stock in this sector, all types of condominium projects were considered. The sample therefore includes units located in buildings of different sizes, having various years of construction and offering a variety of services, as well as all rent ranges on the market.

5 Sources: Centris® system and CMHC (compilation and calculations).

6 Source: CMHC (2016 Secondary Rental Market Survey).

7 With the exception of the mortgage payments, which are based on assumptions, all the operating expenses correspond to the actual expenses of each of the condominiums studied.

8 Sources: Centris® system and CMHC (compilation and calculations).

9 Sources: Comité de gestion de la taxe scolaire de l'île de Montréal (2016-2017 school tax bills) and CMHC (compilation and calculations).

10 Sources: City of Montréal (property assessment roll) and CMHC (compilation and calculations).

11 A premium surcharge is applied when the unit is rented to a third party.

12 Estimated at 2.5% of the rent charged.

13 Source: www.ratehub.ca (average of the five-year fixed interest rates of Canada's big six banks, namely, National Bank of Canada, Royal Bank of Canada, Bank of Montréal, Canadian Imperial Bank of Commerce, Scotiabank and TD Canada Trust).

14 Profitability calculations including taxation would lead to making overly broad assumptions to get realistic results.

15 To perform this analysis, we divided the sample into four equal price ranges based on the property values.

16 It should be specified, though, that an overall vacancy rate of 2.5% was used for each of the ranges, reflecting the market conditions for all rent ranges.

17 Housing units under construction, Ville-Marie and Île-des-Sœurs, February 2017.

18 Construction in 2010 and after: percentage of investors by year of construction
Sources: Ministère des Affaires municipales et de l'Occupation du territoire (MAMROT) and CMHC (compilation and calculations), https://www.cmhc-schl.gc.ca/en/hoficlincl/observer/observer_075.cfm.

19 In the Griffintown sector, which is located in Le Sud-Ouest, the ratio of condominium listings (sellers) to buyers—an indicator of market conditions—is 7.9 to 1. This figure reflects the market conditions in all of Le Sud-Ouest and Verdun.

20 The seller-to-buyer ratio denotes market conditions. The balanced range is between 8 and 10 to 1, while a ratio above 10 to 1 indicates buyers' market conditions.

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