Supply Constraints on New Multi-Unit Residential Developments:

Land shortages and sensitivity to risk hinder new purpose-built rental investment

THE RESEARCH

A fundamental step to meeting CMHC's 2030 aspiration—that everyone in Canada has a home that they can afford and that meets their needs—is to make sure there is an adequate, suitable, and affordable supply of rental housing in Canada.[1] Unfortunately, there is evidence that the development of new purpose-built rental housing has lost ground to condominium development in some Canadian markets since the 1980s. In addition, the arrival of short-term rentals in recent years has also had a negative impact on the supply of rental units for local residents.

Prism Economics and Analysis conducted exploratory research on behalf of CMHC to identify some of the causes of the insufficient supply of new purpose-built rentals in Canada. In particular, this research focused on the perspectives of industry stakeholders and investors, as well as on their perceived constraints to the development of more purpose-built rental projects in Canadian markets. This information will contribute to the development of tools, programs, or measures to expand the number of multi-unit rental projects in Canada.

Prism Economics and Analysis conducted 14 interviews with industry stakeholders or investors operating in different municipalities and provinces in Canada, including managers and executives at property development firms and institutional investors (e.g. pension funds and real estate investment trusts). The report also summarizes a non-exhaustive literature review used to frame the interview questions. Therefore, the report is an exploratory one, and its conclusions are tentative.

KEY FINDINGS

There is evidence pointing toward a lack of new purpose-built rental development in some local markets in Canada. As such, the secondary rental market (e.g. rented condominiums and secondary suites) has provided the main response to the demand for new rental units since the 1980s.[2]

The real estate developers and investors interviewed in this study consider that, even though the approval process for real estate development projects is complex and has uncertain outcomes, the approval requirements and risks are essentially the same for purpose-built rental projects and condominium projects. Instead, these stakeholders offer two reasons for the slow growth in purpose-built rental projects in Canada over the last four decades:

a) competition for scarce land; and

b) sensitivity to regulatory risk.

Competition for scarce land

A major constraint to the flow of investment from institutional investors—who are the principal source of new investment in the rental sector—into purpose-built rental projects is the shortage of land for high- and mid-density development in the markets where they operate.

Generally, purpose-built rental projects are not able to generate a net return for investors in some markets unless they can purchase the land required at a much lower cost than market conditions would dictate. This is due to the underlying need for purpose-built rentals to achieve near-full occupancy to recoup the initial investment, while condominium investors operate under an invest-to-sell strategy. Condominium development has a higher return on investment, which allows condominium developers to outbid rental developers for scarce land.

Sensitivity to regulatory risk

The other major constraint to the flow of investment into purpose-built rental projects is the risk profile of institutional investors such as real estate investment trusts (REITs) and pension funds. These investors are more sensitive than condominium investors are to the same regulatory risk inherent in the approval processes for multi-unit residential projects.

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[1] See appendix A for a glossary of key terms.

[2] However, it is also important to note that there has been a recent uptick in purpose-built rental projects in some markets. For example, CMHC housing starts data shows that apartment starts for the primary rental market in Calgary averaged 936 units annually over 2017-19, up from an average of 335 starts over 2005-16. In Toronto, 3,986 apartment rental units broke ground in 2019, the area's highest number since 1992. Unfortunately, the interviews in this study did not offer insights into the underlying causes of these upticks. Source: Canada Mortgage and Housing Corporation, *Starts and Completions Survey.*

Regulatory risk comprises delay risk and outcome risk:

- Delay risk arises from the time required to commission and complete the multiple technical reports required during the approval process. The amount of capital at risk and the exposure to higher construction costs caused by delays determine sensitivity to delay risk.
- Outcome risk arises from uncertainty regarding the decisions that local authorities will make on key aspects of a project (such as height, number of units, and required community benefits) that will affect its cost and profitability. This uncertainty increases if the project requires amendments to a municipality's official land use plan or zoning by-laws. This uncertainty also increases if a dispute with the municipality leads to an adjudication process.

Condominium and rental projects are subject to the same approval processes and the same regulatory risks. However, investors in rental projects are more sensitive to regulatory risk for two reasons:

- The institutional investors drawn to rental projects often have little or no experience dealing with local approval processes. Therefore, these institutional investors tend to cautiously assess and manage their exposure to regulatory risk.
- Relative to the overall value of a project, rental projects require a greater amount of capital at risk than condominium projects do because condominium developers can reduce their capital requirements by pre-selling units. Additionally, purpose-built rental projects tie up capital for a longer period.

Therefore, rental developers are more concerned about delay and certainty of outcome in the regulatory process because they have substantially more capital at risk. Possible delays and uncertainty are thus more likely to deter typical purpose-built rental investors than condominium developers.

The industry stakeholders interviewed report that, to avoid regulatory risk, pension funds and REITs will often pay a higher multiple of expected net operating income to acquire an existing building rather than invest in developing a new rental project. Institutional investors can manage, although not eliminate, regulatory risk by collaborating with experienced development companies.

IMPLICATIONS

- Regulatory risk biases multi-unit residential development in favour of condominiums rather than purpose-built rental projects. This is due to the sensitivity of different investors to risk and not to the risk itself.
- Regulatory risk also biases investment in purpose-built rentals in favour of existing buildings rather than new buildings. Investing in existing buildings allows institutional investors to avoid the regulatory risk associated with the approval process for building new units.
- Reducing regulatory risk could alter current development patterns in favour of more purpose-built rental projects. Shorter approval times and less uncertainty about outcomes would almost certainly elicit more interest from institutional investors in purpose-built rental projects.
- Providing sites for rental projects at prices that are consistent with expected rents remains challenging. In many urban markets, condominium developers can outbid rental developers for these sites because the condominium investors can expect to earn outsized capital gains.
- There has been a recent uptick in purpose-built rental development in some markets. This should warrant additional research to explore local drivers of this change. Programs and incentives, risk attitude, and changes in housing demand can affect the appetite for new purpose-built rental development.

FURTHER READING

Full report – *Constraints on the Supply of New Purpose-Built Rental Projects: Industry and Investor Perspectives* (https://eppdscrmssa01.blob.core.windows.net/cmhcprodcontainer/sf/project/archive/publications_2/20200717-003_rr_supply_constraints_en_jul23.pdf)

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Other sources for the preparation of this Insight:
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Starts and Completions Survey

APPENDIX A – GLOSSARY OF KEY TERMS

Affordable housing: Housing that costs less than 30% of before-tax household income. For renters, housing costs include, as applicable, rent and payments for electricity, fuel, water and other municipal services.

Suitable housing: Housing that has enough bedrooms for the size and make-up of the resident household, according to National Occupancy Standard (NOS) requirements. Enough bedrooms based on NOS requirements means one bedroom for each cohabiting adult couple; lone parent; unattached household member age 18 or older; same-sex pair of children under age 18; and additional boy or girl in the family, unless there are two opposite sex children under 5 years of age, in which case they are expected to share a bedroom. A household of one individual can occupy a bachelor unit (i.e., a unit with no bedroom).

Adequate housing: Housing that does not require any major repairs, according to residents. Major repairs include defective plumbing or electrical wiring, or structural repairs to walls, floors, or ceilings. Adequacy is self-reported and assessed based on responses to a Census/survey question guided by the explanation of what constitutes major and minor repairs and regular maintenance.

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