Why Isn't a Lot More Purpose-Built Rental Housing Being Built in the Greater Toronto Area?

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Executive Summary

The Greater Toronto Area ("GTA") has an almost insatiable need for more rental housing despite a short-term uptick in vacancy rates resulting from the pandemic. So, the question is often asked: Why don't we see the start of many more new purpose-built rental projects?

This paper summarizes a recent study done by Altus Group for CMHC which provides the answer to the above question: **expected rents are inadequate to generate widespread interest in building new rental projects, even with the low-interest rates in place in 2020.**[1]

The rent income required to cover the costs of acquiring sites, constructing buildings (hard and soft costs and contingencies), and providing a risk-adjusted competitive return on investment (profit) generally exceeds the revenue achievable in the rental marketplace. New rental projects are typically not financially viable.[2] However, there are exceptions (e.g., owners of existing rental buildings with surplus site area suitable for a new building or the redevelopment of under-performing shopping centres). The viability gap is the smallest for the low-rise apartment pro forma in the 905 regions.

The paper also presents the authors' policy options for significantly increasing the production of new rental housing including options to reduce the land cost component of building new projects.

1 Altus Group (2021). 'The Economics of New Purpose-Built Rental Housing Development in Selected Canadian Markets.' Prepared for CMHC. [Online] Available: https://eppdscrmssa01.blob.core.windows.net/cmhcprod-container/sf/project/archive/research_6/the-economics-of-purpose-built-rentals_wcover.pdf

2 It should be noted that the Altus Group research was done at a time of very low interest rates. A continued rise in interest rates will operate in the direction of the reduced financial viability of new rental projects.

An overview of the Altus Group study

In 2021, CMHC retained the Altus Group to analyze the economics of new purpose-built rental projects in six census metropolitan areas, including Toronto. The Altus study uses a pro forma framework to assess the economics of developing new purpose-built rental projects.

The pro forma scenarios are based upon a combination of variables:

- **Type of project/location:** based upon quality, bedroom mix and location within a census metropolitan area;
- **Rents:** achievable market rents versus required economic rent to make the project financially feasible; and
- **Land costs:** market land costs versus zero land costs.

A financial pro forma starts with the total cost of developing a purpose-built rental project, then estimates future annual revenues, operating costs and financing (equity, mortgage payments), and calculates the investment return to the proponent. Finally, this return is compared to the target return expected by the investor to determine whether the project is financially viable or not. A simple way of assessing financial viability is to compare economic and market rents for each scenario.

This paper describes the results of six financial pro formas prepared for the Greater Toronto Area ("GTA") (approximated by the Toronto census metropolitan area) – three with market land costs included and three with land costs at zero. The zero land costs scenario is relevant because owners of many older apartment buildings within the GTA can accommodate new projects on part of their sites.

Figure 1: Characteristics of Rental Projects Analyzed, GTA, 2020

	Basic Project	Medium Project	High-End Project
	905 Area	City of Toronto postwar suburbs	City of Toronto not prime location
Project Type	Low-Rise	Mid-Rise	High-Rise
Project Size	50 Units	100 Units	150 Units
Average Square Feet	750	690	670
Quality of Finishes	Basic	Medium	High
Parking Type	Surface	Mix of Surface / Underground	Underground
Bedroom Mixes	Bachelor – 0%	Bachelor – 5%	Bachelor – 10%
	One Bedroom – 35%	One Bedroom – 50%	One Bedroom – 45%
	Two Bedroom – 55%	Two Bedroom – 40%	Two Bedroom – 45%
	Three Bedroom – 10%	Three Bedroom – 5%	Three Bedroom – 0 %

Source: CUR based on Altus Group

GTA rental projects: vary by location, building height, quality and bedroom mix

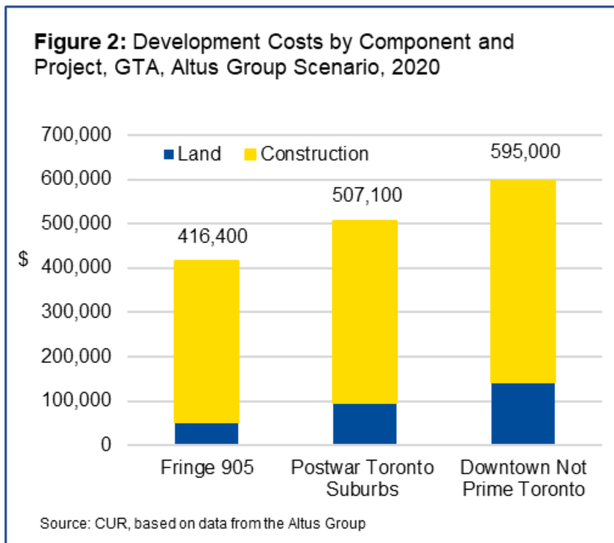
Figure 1 summarizes key characteristics and differences between the three rental development scenarios examined by the Altus Group.

The characteristics of the rental projects reflect both differing land costs and the perceived target renters. For context, moving from the 905 suburbs to the central area, the height and quality of projects increase while the average unit size and bedroom mix become smaller:

- Projects located in the 905 fringe suburbs are typically low-rise, smaller buildings with larger suite sizes, basic finishes, and surface parking.
- Projects located in the "postwar suburbs" (sometimes referred to as the "inner suburbs") of metropolitan Toronto tend to be mid-rise buildings with medium finishes, smaller unit sizes and a mix of surface and underground parking.
- Projects located in central Toronto have the tallest and largest buildings with the most petite unit sizes, a higher quality of finishes and underground parking.

Development costs of GTA projects

Figure 2 summarizes the development costs by component per unit for each of the three project scenarios. Development costs include construction costs (hard, soft and a contingency allowance).[3]



Development costs including land costs

Highlights of the development cost scenarios include:

- Development costs per unit range from $416,400 for the hypothetical 905 project to $595,000 for the hypothetical central area project – a difference of 42%. This disparity occurs even though the average unit size is 10% smaller in the central area project; and
- About half the difference per unit of the development scenarios is due to higher land costs in the central area ($89,000 more than in the 905 scenario). The construction of underground parking and the use of higher quality finishes account for the other half of the difference.

3 Hard construction costs include labour, materials, and general and subcontractor fees. Soft costs include outlays such as for approvals, architects, marketing, and interim financing.

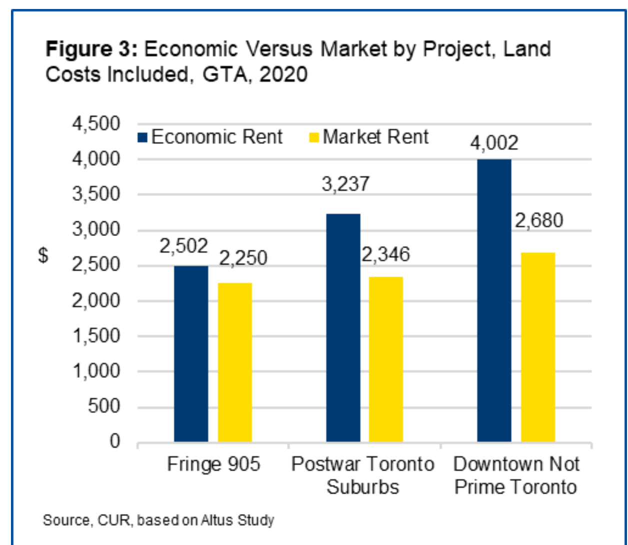
Development costs excluding land

If the land component is excluded, the development costs are not only reduced but the locational differences are lessened:

- The per-unit development costs without the land costs vary between $453,100 in the central area to $363,500 in the 905 suburbs: and
- The percentage difference in costs between the central area and the 905 suburbs is 22% compared to 35% when land costs are included.

Economic rent exceeds market rent for all three projects with land costs included with the viability gap being smallest for the 905 suburban project

Figure 3 examines the economic viability of projects with land costs included on a per unit basis by comparing economic with market rent per unit.[4]



4 The Altus Group report provides five alternative measures of performance indicators in recognition that all investors in new purpose-built rental projects are not the same and may utilize different measures of performance. Their analysis relies on the assumption of a minimum 10% for an annual cash flow plus loan principal payments divided by the project's equity requirement expressed as a percentage (called cash-on-cash return including loan principal payments).

Highlights include:

- Market rent falls short of economic rent for all three projects.
- However, the shortfall is much smaller for the 905 project ($252 or 10%) than for the central area project ($1,322 or 33%), with the shortfall for the Toronto suburban project falling in between.

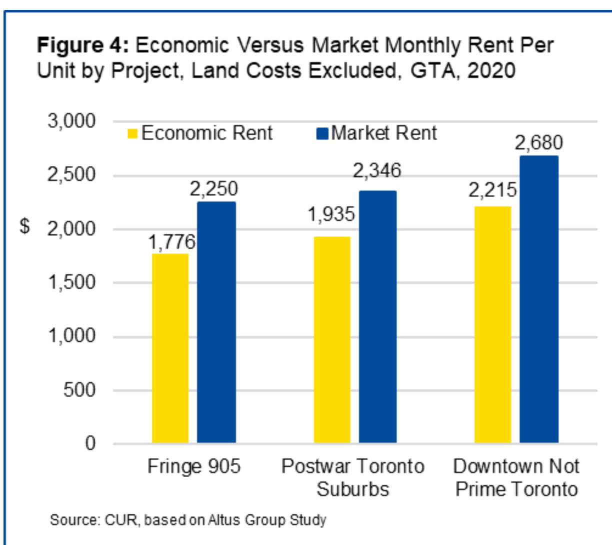
This wider gap between market and economic rents for the Toronto projects reflects higher land costs and the cost of building underground parking and higher quality finishings.

Applying the 'lowest hanging fruit' principle, stimulating new rental projects in the fringe 905 locations would likely produce the most significant rental housing with the least cost to governments.

With land costs excluded, market rent exceeds economic rent – all projects are viable

Figure 4 repeats the comparison in Figure 3, except that the pro forma calculation of economic and market rent excluding land costs.

All three projects are now viable, with investors projected to earn a 10% cash-on-cash return, including loan principal repayment on their equity.



There are three types of investors who can calculate their pro forma with land at nil or who can write down part of their land costs:

- Owners of older, purpose-built, high-rise rental projects, often referred to as "towers in the park" – projects where the existing building footprint is small relative to the site size;
- Owners of existing older low-rise rental buildings that obtain a re-zoning of their sites to accommodate high-rise buildings – tearing down existing structures to build at higher densities while satisfying municipal policy to compensate existing tenants and/or include an affordable housing component in the new project; and
- Owners of under-performing shopping centres who pursue higher-density residential redevelopment for all or part of their properties.

Conclusions

The Greater Toronto Area ("GTA") has an almost insatiable need for more rental housing despite a short-term uptick in vacancy rates resulting from the pandemic. So, the question is often asked: Why don't we see the start of many more new purpose-built rental projects?

This paper summarizes a recent study done by Altus Group for CMHC which provides the answer to the above question: **expected rents are inadequate to generate widespread interest in building new rental projects, even with the low-interest rates in place in 2020.**[5]

The rent income required to cover the costs of acquiring sites, constructing buildings (hard and soft costs and contingencies), and providing a risk-adjusted competitive return on investment (profit) generally exceeds the revenue achievable in the rental marketplace.

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5 Altus Group (2021). 'The Economics of New Purpose-Built Rental Housing Development in Selected Canadian Markets.' Prepared for CMHC. [Online] Available: https://eppdscrmssa01.blob.core.windows.net/cmhcprod-container/sf/project/archive/research_6/the-economics-of-purpose-built-rentals_wcover.pdf.

New rental projects are typically not financially viable.[6] However, there are exceptions (e.g., owners of existing rental buildings with surplus site area suitable for a new building or the redevelopment of under-performing shopping centres). The viability gap is the smallest for the low-rise apartment pro forma in the 905 regions.

Postcript

Policy options for enhancing the economic viability of new purpose-built rental projects in the GTA

For new purpose-built projects to become much more commonplace in the GTA, some combination of the following actions is required:

- Increase rental revenue (e.g., higher rents) and reduce operating costs (e.g., property taxes);
- Reduce risk-adjusted rates on return (e.g., exempt newly built purpose-built projects from rent controls over the life of the project);
- Reduce government financial burdens on land costs (e.g., lowering development charges) and increase the supply of sites intended exclusively for purpose-built rental projects (e.g., establish planning zones where only rental projects are allowed to be built to reduce competition for sites from condominium developers);
- Reduce construction costs (soft and hard) by expediting planning approvals and encouraging factory-built construction; and
- Reintroduce income tax incentives for new rental projects (such as were in place in Canada before federal tax reforms of 1972, which were partially reintroduced in 1974-1982 and are currently in force in the United States).

Policy options involving reducing or eliminating land costs

The proforma analysis by the Altus Group demonstrates the efficacy of reducing land costs as an incentive for creating additional purpose-built rental projects.

- Possible options for increasing the supply of sites for rental housing and at the same time lowering land costs include:
- Providing publicly-owned sites to rental developers at a less than market price;
- Designating and zoning locations for purpose-built rental housing development only (i.e., exclude condominium development) to encourage competition amongst developers; and
- Requiring that applications for redeveloping shopping centres or existing older lower-density rental apartment sites designate a significant percentage, if not all, of the new residential units as purpose-built rental housing.

If mortgage interest rates continue to rise, relief from onerous interest costs will become a viable option to encourage new rental projects.

6 It should be noted that the Altus Group research was done at a time of very low interest rates. A continued rise in interest rates will operate in the direction of the reduced financial viability of new rental projects.

References

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