URBANATION

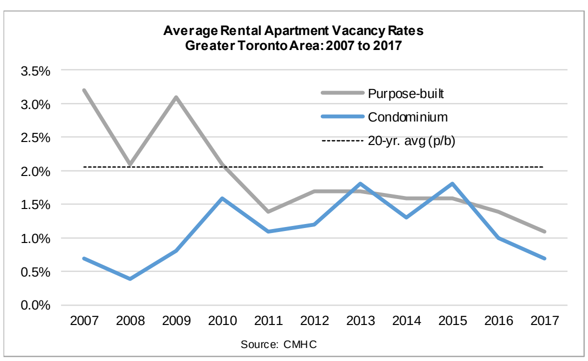
November 29, 2017

Review: 2017 CMHC Rental Survey

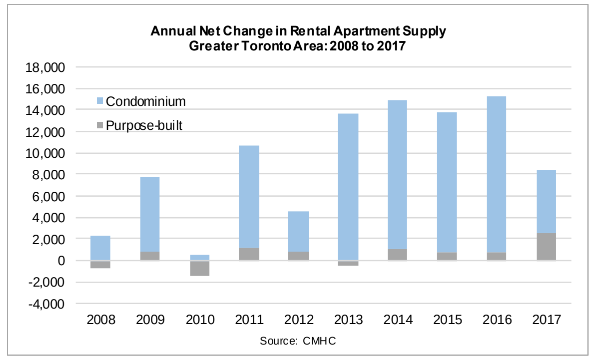
A Reminder that Condo Investors Can't Fill the Rental Supply Gap

Canada Mortgage and Housing Corporation (CMHC) released its 2017 rental survey results yesterday, representing the latest in a series of important data releases in recent weeks that together provide a comprehensive look at the current state of the local rental market. The main message conveyed by the data is that the rental market has become further undersupplied this year, despite maintaining a record level of condo investment.

The decline in vacancy rates revealed by the CMHC survey was widely anticipated. Urbanation has been tracking the dramatic tightening in rental conditions throughout the year, to the point that it came as a surprise that purpose-built vacancy rates weren't less than 1.0% (a 16-year low) and condo vacancy rates weren't below the reported 0.7% (second lowest ever recorded). Still, the 22% fall in the total number of vacant purpose-built and condo rentals was the steepest decline since 2011, when vacancy rates for purpose-built units came down from above 2%. In fact, it would now take an 82% increase in vacant units to bring the purpose-built rate back to its 20-year average of 2.1% and the condo vacancy rate up to its 10-year average of 1.1%.

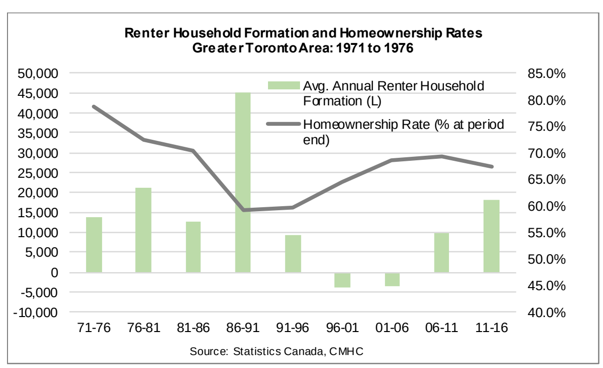


Perhaps the most striking statistic from the 2017 CMHC release was the annual increase in total supply of rental apartments, which dropped to its lowest level in five years. At 8,485 units, the growth in purpose-built and condo rentals this year was 44% lower than the 15,288-unit increase in 2016. This occurred despite a 10-year high net increase of 2,577 purpose-built rentals. Part of the explanation stems from a slowdown in condo completions this year. But an even more important factor lies in the lack of growth in condo rental investor ownership (discussed later). Indeed, the 5,908-unit net increase in condo rental supply was down 59% from last year — a dramatic pullback for a market that has relied on an annual increase of around 14,000 condo rentals since 2013.



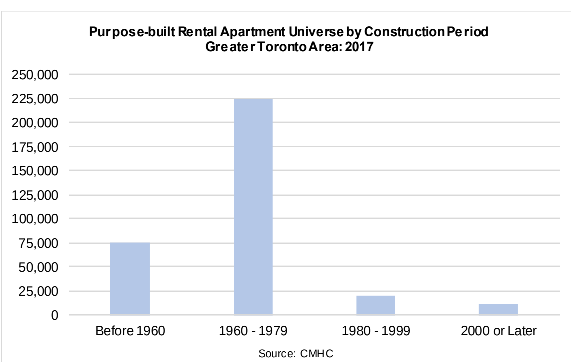
This substantial slowdown in new supply is made more troubling against the backdrop of rental demand, which the 2016 Census confirmed has risen to its highest level in 25 years. Renter household formation in the GTA reached 18,178 per year between 2011 and 2016, almost doubling the rate recorded between the previous two Census periods as the homeownership rate declined for the first time since the 86-91 period (the last time ownership affordability was as low as it is now).

This tells us that in the absence of a measurable change in the supply of secondary rentals other than condominiums (i.e. units within single-family dwellings, etc.), the gap between rental demand and supply reached 10,000 units last year. And this excess will carry forward and accumulate, creating large shadow demand that will continue to weigh on the market in coming years if supply doesn't ramp up.

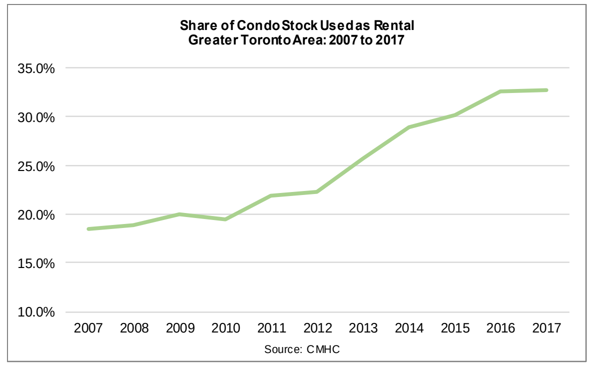


A quick look back at the evolution of rental demand in the GTA also tells the story of a remarkable turnaround from the net decline in renter households seen between 1996 and 2006. The falling demand during this time partly explains why builders weren't constructing rentals, despite rent controls being lifted in 1998 for new units. The rear-view also provides historical benchmarks for rental demand levels. Over a 25-year period between 1971 and 1996, the average annual increase in renter household formation averaged over 20,000 units per year, during which time the homeownership rate averaged 68% — in line with the current rate. While a return to rental demand at 45,000 units per year seen in the late 80s/early 90s as homeownership plunged to 59% is unlikely, a movement back up to 20,000 units per year is likely arriving as we head into 2018.

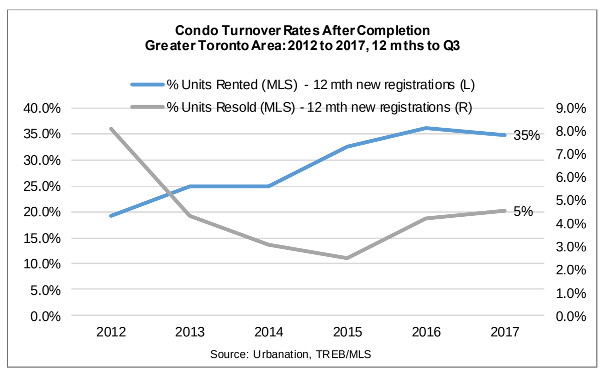
The trouble for the market, as we're learning, is that condos are unable to close the gap between today's level of rental demand and the amount of new purpose-built supply, despite representing 94% of the net increase in rental units over the past decade in the GTA. This is made more difficult through the recent extension of rent control to new units, as Urbanation has previously written, which creates a more difficult environment for investors to hold onto condo rentals, adding instability for the market's primary source of new supply — one that already lacks the highly sought virtues of professional management and security of tenure. CMHC's tally of purpose-built rentals by construction date speaks loudly of the challenges facing today's market, revealing that less than 5% of the stock was built in the past 37 years.



Surely, the record high level of condo development will ensure that new rental units will continue to flow into the market in the coming years — but it won't likely be enough to meet demand, even with the recent increase in purpose-built development. Already, we are seeing that the share of units used as rentals is levelling out. The 32.7% of units used as rentals was basically unchanged from 2016, which followed a sharp rise from 18.5% in 2007. Within their report, CMHC made the important mention that the share of newly completed condos that were used as rentals declined to 48% in 2017 from 50% in 2016.

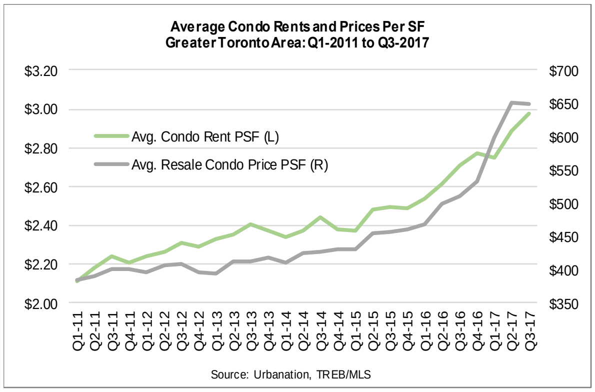


CMHC's findings were consistent with Urbanation's data on turnover for recently registered condominiums, showing that 35% of new completions were rented through MLS in the past year, edging down from 36% last year. This has occurred as the share of condos resold through MLS post-registration has risen, reaching a five-year high of 4.6% (note: this does not account for assignment sales occurring prior to registration).

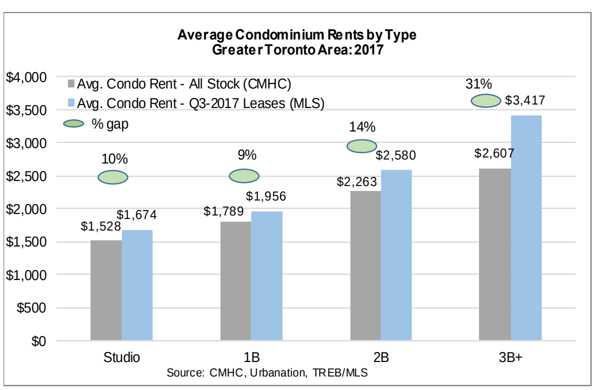


The shift (albeit small) from investor holding to investor selling was largely motivated by the quick acceleration in resale prices attracting more pre-construction buyers to realize huge gains made during the development period. Reaching as high as 30% annual appreciation by mid-2017, resale prices were suddenly outstripping rent growth by ratio of 3-to-1, despite double-digit growth in rents that allowed most investors who bought several years earlier to achieve a cash-flow positive position.

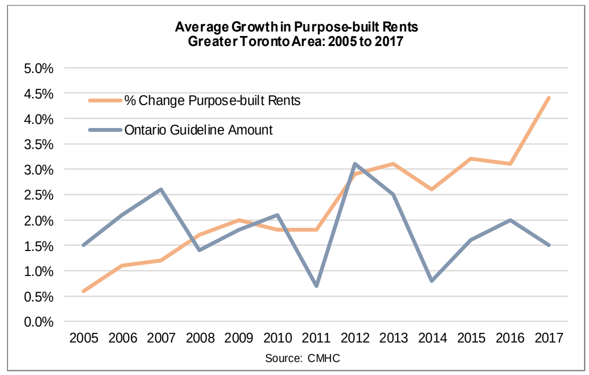
In the near-term, the recent flattening in resale prices and continued fast growth in rents should hold the share of investors in the condo rental market steady. The greater risk to rental supply may come in a few years, as those investing at today's pre-construction prices potentially face a rental market that no longer supports positive cash flow, which is further complicated by rent control.



However, developers and well capitalized investors with a long-term view should be encouraged by the widespread growth in rents reported for the market this year. CMHC's survey, which covers existing condo tenants regardless of when their lease was signed, showed average rents up 10% across the board to $2,078. Comparing CMHC's data to Urbanation's tracking of new condo leases signed through MLS (i.e. a measure of existing versus turnover rents) reveals that investors were able to achieve notably higher rents in the open market recently. Leases transacted in Q3-2017 for one bedroom units were 9% higher than the average for the whole stock, with even tighter conditions for two bedroom and three bedroom units showing turnover premiums of 14% and 31%, respectively.



Rent-controlled purpose-built operators also saw relatively strong increases in portfolio rents, achieved though unit turnover (which actually declined from 15.9% to 14.6%) and investment in capital expenditures (which Urbanation and FRPO reported over $5 billion was spent on significant purpose-built renovations since 2012 in Ontario). At 4.4%, purpose-built rent growth was nearly three times the guideline amount for 2017 (1.5%) and the fastest rate recorded since 2001. The tightness in purpose-built rental market conditions can be seen through the gap between realized rent growth and guideline increases, averaging 185 basis points over the past four years.



Ultimately, the CMHC survey results sound the alarm louder for market opportunities to build new rental apartments in the GTA. The report references the high for purpose-built units currently under construction in the GTA — but this should not act to crowd out future development. From a demand standpoint, there is much more runway room left, even with record amounts of condo development underway. In fact, if you take the number of vacant purpose-built units and add in the inventory under construction, total current and future available supply is less than 10,000 units. That's equal to 0.5 units for every renter wanting to form a household today in the GTA. Rental construction needs to at least double.