URBANATION

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A Window Into the World of Condo Investors

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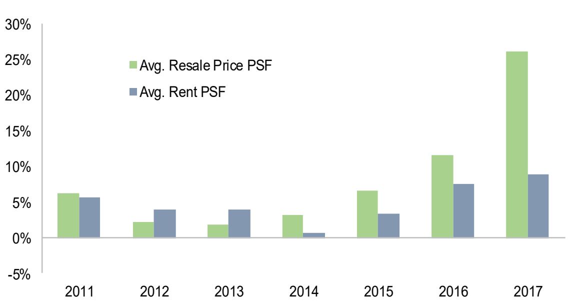
If you want to understand the GTA housing market, you have to get into the heads of condo investors. While the focus is often on foreign investors, the key to the future of the region's real estate market may be held by domestic investors. Never before has the role of these investors been so great in generating demand for and influencing future supply of condo units. With tougher qualification criteria, rent control and rising interest rates potentially working to change the economics of that investment, how will these investors react? What's their prime motivation? Cash flow or capital appreciation? Any change in their behaviour might have implications for the condo market — which last year accounted for a record-high of no less than 80% of all new home sales in the GTA.

Chart 1
Condo Price and Rent Growth: GTA



Source: Urbanation Inc., CIBC

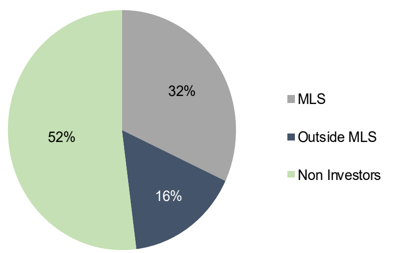
To get a better understanding of this key market, Urbanation and CIBC have combined efforts to provide a first ever, close look at condo investors in the GTA through the lens of both qualitative and quantitative research.

Current Market Conditions

The GTA condo market has experienced tighter conditions in recent years. Demand for condos, both for sale and for rent, has been elevated, while the turnover in stock has been trending down. Because the majority of pre-sale investors hold onto their units, very little new supply enters the resale market as projects reach completion. Furthermore, high housing prices have made move-up buying more difficult for existing condo occupants, in addition to creating greater barriers to entry for first-time buyers and causing renters to stay put. This situation has been compounded by a decline in completions, which fell to a five-year low in 2017. The combined effects of higher demand and lower supply were felt across both market segments, with average resale condo prices increasing by 26% during the year and rents growing by 9% (Chart 1).

And condo investors are a big part of this picture. Based on 2017 data on new condo closings, rental investors accounted for no less than 48% of the GTA's newly completed units, of which two-thirds were listed within the MLS system (Chart 2).

Chart 2
Rental Investors Account for Half of Condo Sales



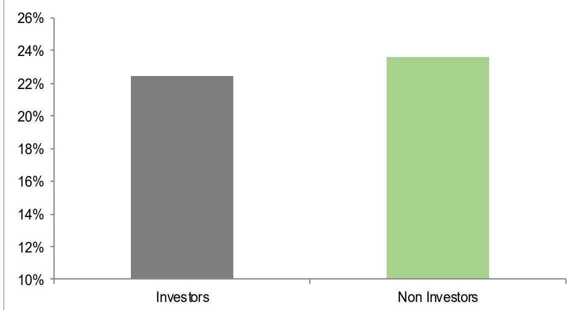
Source: Urbanation, CMHC, CIBC

Condo Investors — Lifting the Hood

Using sales and rent information for more than 4,000 condo pre-sale transactions that closed in 2017 obtained from Urbanation, and aligning it with the matching purchase price and mortgage information obtained from Teranet, we were able to shed some light on that segment of the market. The goal here was not to make bold predictions, but rather to provide hard data on rental condo investors that is currently missing from the marketplace. By doing so we hope to enhance the understanding of the drivers behind the important and vibrant GTA housing market.

- Just over 20% of condo investors purchased the property with no mortgage. Note that the share of all cash buyers among non-investors is modestly higher, probably reflecting downsizers with substantial equity (Chart 3).

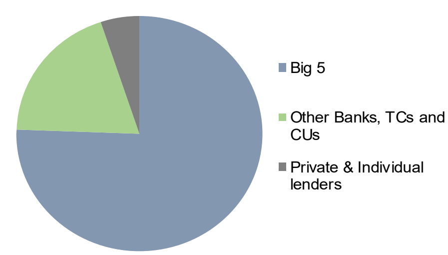
Chart 3
Share of Buyers with No Mortgage



Source: Urbanation, Teranet, CIBC

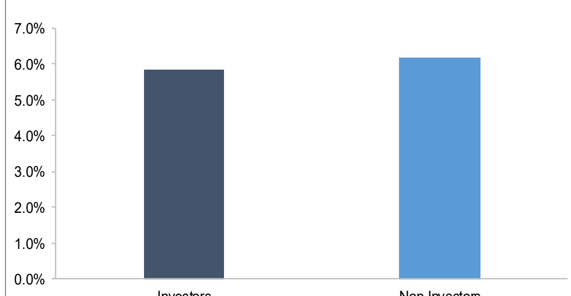
- The 'Big 5' banks provided three quarters of credit to investors, and smaller banks, trust companies and credit unions accounted for close to 20%. Private and individual lenders accounted for 5% in terms of dollar amount, but close to 10% in terms of the number of transactions (Chart 4). Interestingly, the distribution of credit providers was almost identical for non-investors (Chart 5).

Chart 4
Breakout of New Condo Mortgages by Lender - Investors



Source: Urbanation, Teranet, CIBC

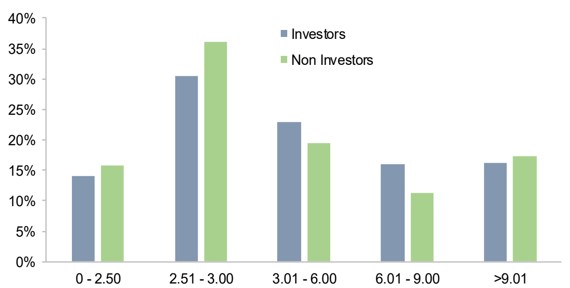
Chart 5
Share of Private and Individual Lenders



Source: Urbanation, Teranet, CIBC

- At the very low and very high ends of the interest rate spectrum lenders tended not to distinguish between investors and non-investors. However, for the range between 3.5% and 9% investors were viewed differently, with creditors requiring higher rates for investors. Close to 30% of investors had an interest rate of more than 6% and 13% had rates that were higher than 9% (Chart 6).

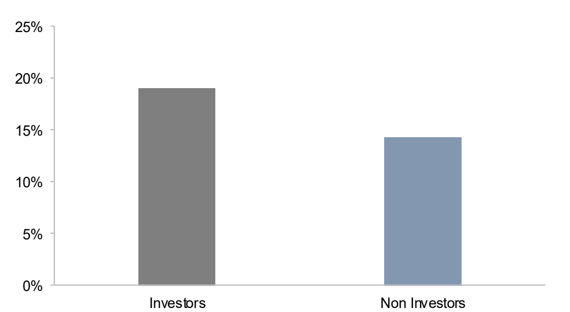
Chart 6
Mortgage Distribution by Interest Rate



Source: Urbanation, Teranet, CIBC

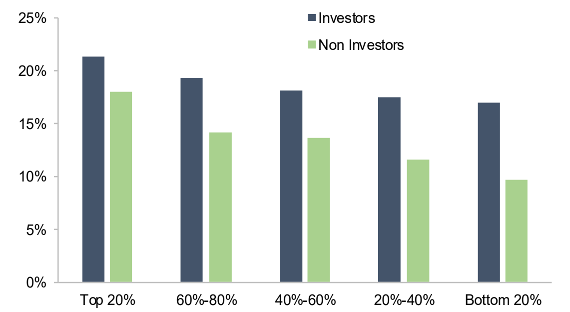
- In terms of the down payment, investors on average tended to provide the minimum required — 20%, while non-investors could go below due to the availability of mortgage insurance and deposit loans (Chart 7). Note that more expensive units tended to see a higher percentage down payment (Chart 8).

Chart 7
Average % Down Payment



Source: Urbanation, Teranet, CIBC

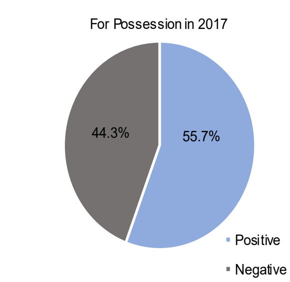
Chart 8
Average Down Payment by Unit Value Percentile



Source: Urbanation, Teranet, CIBC

- At this point no less than 44% of investors with a mortgage that took possession in 2017 are in a negative cash flow position in which rental income falls short of mortgage payment (principal + interest) and condo maintenance fees (Chart 9). Excluding the principal payment, this ratio falls to 27%. Among investors with positive cash flow, average monthly net income was just over $360.

Chart 9
Rental Cashflow Relative to Mortgage Payments and Condo Fees



	Positive	Negative
$0.00 - $500	78.4%	45.4%
$500.01 - $1000	16.3%	20.1%
>$1000	5.3%	34.5%
	100.0%	100.0%

Source: Urbanation, Teranet, CIBC

- At the same time those investors experienced exceptional returns. The average resale price per sf for units that turned over in the newly registered buildings was 51% higher than their average pre-sale price per sf, with the length of time between pre-sale launch and registration averaging five years. Based on a 20% investment of approximately $75,000, that equaled a 155% return on investment before closing costs. And with rents averaging just over $2,000, cap rates net of condo fees averaged over 5% (Table 1).

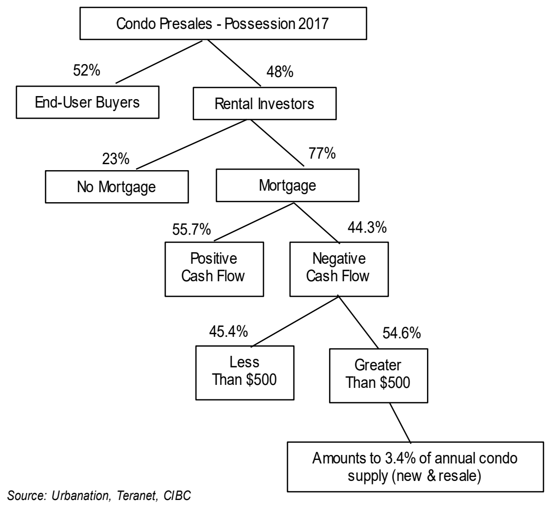
Table 1	
Investment Returns	
New 2017 Registrations	
Avg. Pre-sale Price PSF	$541
Avg. Resale Price PSF	$817
% Appreciation	51.0%
Avg. Months Pre-sale to Registration	60.28
Avg. Years Opening to Registration	5.0
Avg. Size (sf)	692
20% Dow n Investment	$74,874
ROI	155%
Annualized ROI	30.9%
Average Rent	$2,013
Cap Rate*	5.2%
**Unleveraged and net of condo fees	
Source: Urbanation, CIBC	

Chart 10 puts the magnitude of that issue in perspective by summarizing the information discussed so far. The bottom line is that if all investors that took possession in 2017 and now face negative cash flow of more than $500 a month decide to sell, that extra supply will amount to just under 1,400 units or 9% of new supply and only 3.4% of total supply when the resale market is included (Chart 10).

What's the Motivation?

With many investors experiencing a negative cash flow alongside a substantial capital gain, understanding the motivation is key to assessing the sustainability of that trend. To that end we supplemented our data analysis as reported earlier with qualitative information obtained from a focus group discussion with

Chart 10
Rental Investment — A Market Perspective



Source: Urbanation, Teranet, CIBC

some of the top condo investment brokers in the GTA. The purpose of the meeting was to gather insights into the characteristics and expectations of condo investors. Most of the agents have been working with investors for at least the past seven years, representing 80% or more of their clients.

Most of the agents reported that international buyers represented less than 10% of their clients. All agreed that local immigrants represent a significant share of investors. Many of the agents' investor clients are repeat buyers and some hold multiple units as rentals. In general, investors are between the ages of 40 and 60 with discretionary wealth, and often approach condo investing as part of their retirement savings strategy or as a plan to help their children get into the market.

For most investors, the goal is to put down 20% on a pre-sale unit, experience price appreciation over the course of development, and rent the unit upon completion at a level that covers holding costs and pays down mortgage principal. Some investors have been willing to make larger down payments to achieve neutral cash flow, while others use losses to limit their overall tax burden.

In general investors aren't concerned with achieving exceptionally strong price appreciation, particularly foreign buyers who view Toronto as a safe haven. There appears to be a high degree of confidence that interest rates will remain relatively low and that rents and prices will continue to rise. Most agents expressed that it was difficult to foresee a scenario in which investors would flee the market, and that only a severe recession and or a sudden 200-300 basis-point rate hike would cause a substantive change in behaviour among investors.

A recent development in the market highlighted as a potential risk is the higher incidence of investors having difficulty closing (although still a small percentage), due to tighter bank lending regulations and some having purchased multiple pre-sale units with similar completion dates. As a result, assignment sales have become more common and private mortgage lenders have started springing up.

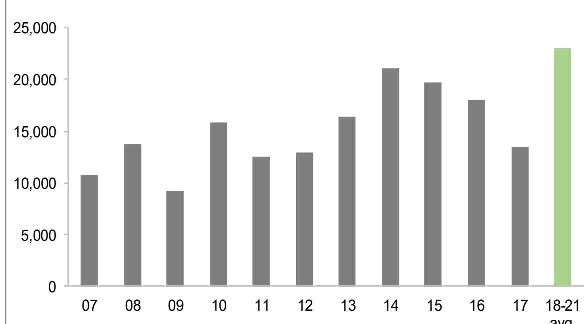
What's in the Pipeline?

Because most units that will reach completion over the next couple years were purchased prior to the run-up in prices that began in 2016, returns will continue to be high for these investors should the market remain stable, and holding costs will still likely be covered by rents for the most part. However, by 2021, the increased supply of new units (Chart 11) and the changing economics of holding condos as an investment might represent a challenge.

We estimate that for new units in development that were pre-sold over the past year and are tentatively scheduled for completion in 2021, in order for carrying costs to be covered with a 20% down payment, rent would need to rise by 17% over the next four years if there was no change in mortgage rates, by 28% if rates increased by 100 basis points, and by 39% if rates rose by 200 basis points.

Selecting the middle scenario as representing the baseline projection for interest rates would require rents to increase by an average of roughly 7% per year. While not out of the question given last year's rise and the expected growth in rental demand, it might be difficult to achieve and potentially could lead to some softening in investment activity. However, given the estimated magnitude of such a development (as discussed earlier) and the likelihood that some of that lost activity will be replaced by end-buyers' demand, we suggest that the slowing in that space in the coming years will be manageable from an overall market perspective.

Chart 11
GTA Condo Apartment Deliveries



Source: Urbanation, CIBC

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