URBANATION

2023 GTA Condo Investment Report

By Urbanation with CIBC Economics
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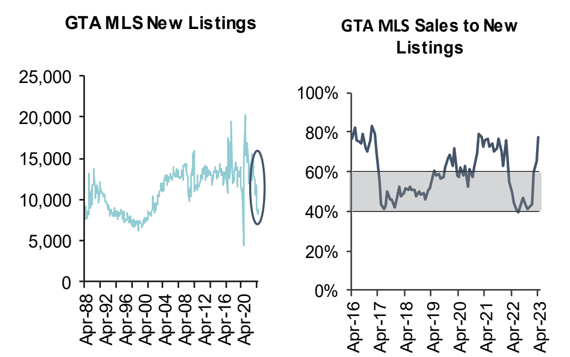
It’s not yet a typical spring market in the GTA, but early signs of stabilization are already evident. The average number of days in the market is starting to fall and bidding wars are more common. Buyers are trying to offset the sting of higher interest rates by increasingly focusing on less expensive homes. The share of homes selling for more than $1 million is currently under 40% — down notably from the near 60% seen last year. The average mortgage size in the GTA fell by 17% over the past year.

While sales in the resale market are approaching pre-pandemic levels, new listings continue to fall to a level not seen since the 1991 recession (with the exception of the brief decline during the covid recession). That lack of supply in the resale market is working to stabilize prices and has the Toronto housing market moving into sellers’ market territory (Chart 1).

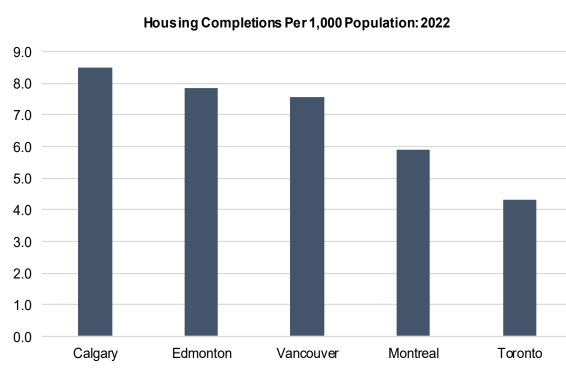
Chart 1: The GTA Resale Market



The supply situation does not look any better in the new construction space. Per capita housing completions in Toronto dropped to a more than 20-year low in 2022 and ranked last among major centres (Chart 2).

While GTA housing completions should see some improvement in 2023 and the few years that follow as the record number of condos currently under construction in the GTA (101,000 units in Q1-2023) are finished, the sharp drop in presales since the second half of 2022 as reported by Urbanation will eventually pull completions back down as immigration is set to rise to new highs.

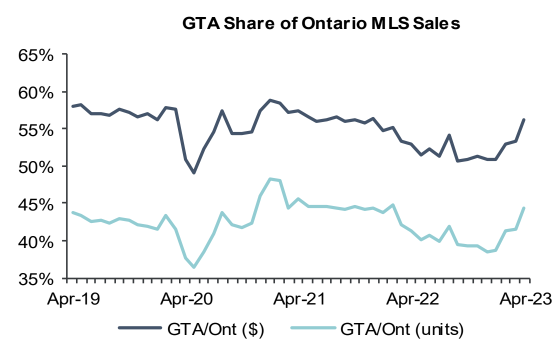
Chart 2: Low Level of Completions in the GTA



The mismatch between supply and demand is therefore expected to get worse given the very strong growth in the Toronto population. A report published earlier this year by CIBC economics indicated that the combination of permanent resident and non-permanent resident arrivals from outside Canada in 2022 amounted to close to one million, representing an unprecedented swing in housing demand in a single year. The number for 2023 is expected to be even higher. We estimate that close to one-third of that total will end up in Toronto.

Granted, other demographic forces are moving in the opposite direction. During the year ending July 2022, no less than 21,400 people left Toronto for other provinces (net interprovincial migration) while 78,000 moved to other census metro areas (CMAs) in Ontario (net intra-provincial migration). Those numbers are clearly impacting the housing market. Despite the recent increase, Toronto's share of resale activity in Ontario is still below the level seen in 2019 (Chart 3). No doubt that reduced affordability in the GTA plays a significant role behind that trend.

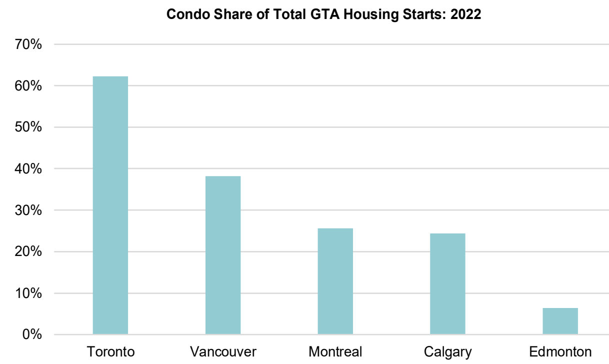
Chart 3: GTA's Share of Ontario Resales



Investors in the Condo Market

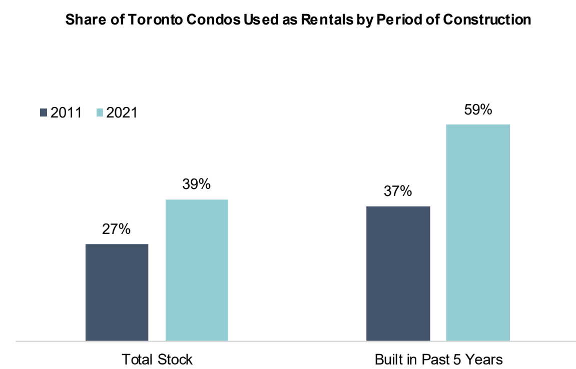
In the GTA, the condo market does all the heavy lifting for housing supply – where condos represent the highest share of residential construction in the country (Chart 4). Investor demand is therefore of critical importance for the supply outlook – if investors aren't buying, developers won't be building. More purpose-built rental projects are needed, but we are a long way from being able to rely on traditional rental units to drive construction in Toronto.

Chart 4: Condo Starts – Toronto Leads the Way



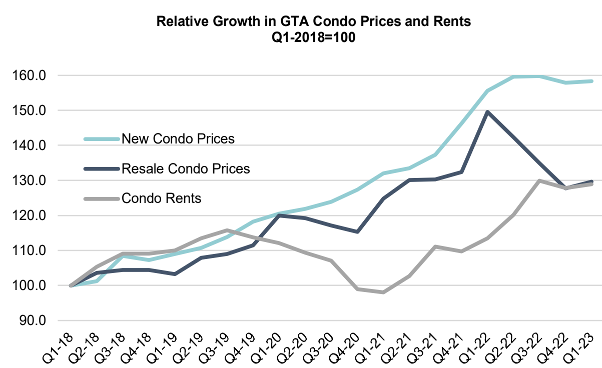
According to the Census, rental investors account for 39% of the total condo stock in Toronto, and 59% of units built in the past 5 years – 20 percentage points higher than a decade ago (Chart 5). But can we continue to see that growth in the future? The economics of investing and financial position of investors may challenge this trend. Given the importance of condo investors to rental supply in the GTA, we need to explore further.

Chart 5: Rising Share of Condos for Rent



In order for new condo investing to continue to make economic sense over the long-term, new condo prices should generally grow in line with resale prices and rents. Recently, however, we have seen a big deviation, which could make it increasingly difficult for investors to earn returns. In the past five years, new condo prices have increased 58% — nearly double the growth in condo resale prices and rents (Chart 6). These increasingly higher priced new condo units will be reaching completion in a higher interest rate environment, requiring larger financial obligations. The question is how will this affect the cash flow position of condo investors, and to what extent will this change behavior of investors, who are arguably the single most important market segment for housing supply? To understand this, we need to drill into the data.

Chart 6: The Condo Market – Price vs. Rent

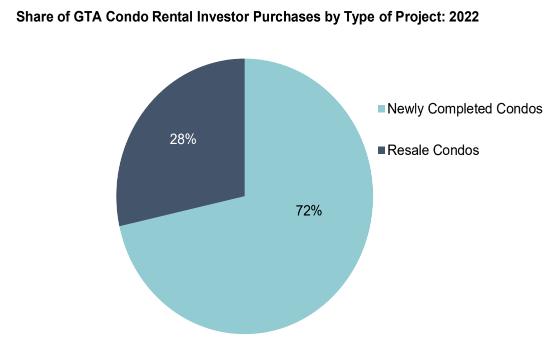


The Economics of Condo Investment

Using Urbanation's rent data for condo investor purchased units and matching it with registered sale price and mortgage information obtained from Teranet, we were able to shed some light on the financial situation of investors.

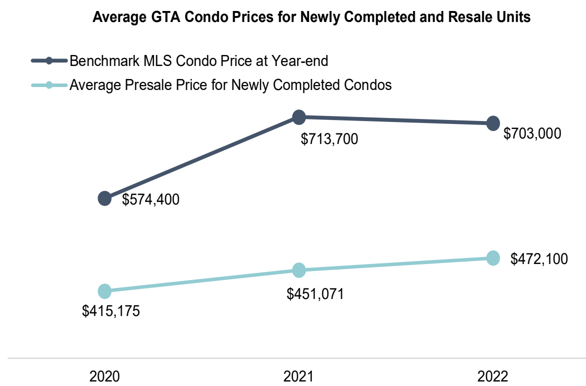
We found that the strong majority (72%) of condo rental investors buy new as opposed to resale units (Chart 7). The main advantage of investing in rental units through new condos is the time it takes for development to occur — the average time between presale launch and completion is approximately five years (and growing) — which has historically been sufficient time for resale prices to catch up to presale prices and for rents to reach a level that can cover ownership costs, providing strong leveraged returns

Chart 7: Investors Focus on New Condo Units



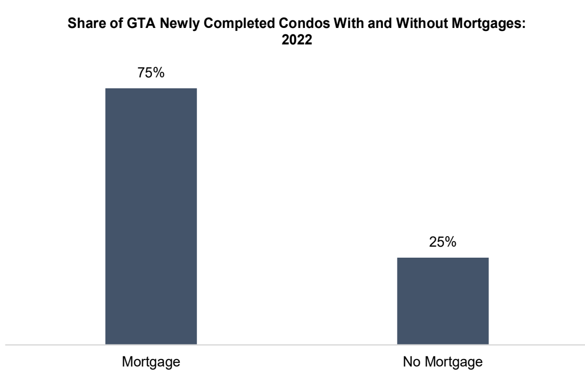
The first important point to make is that new condos reaching completion are experiencing notable appreciation from the point of presale. Again, understanding that the majority of units finishing construction were presold five years earlier before ground was broke, the average closing price for new condos in 2022 was 33% lower than the year-end MLS benchmark price for resale units, even with some depreciation in the market over the past year (Chart 8). So, the risk for right now isn't that most new condos won't be worth their presale prices in the resale market at closing, although that may be an issue that arises in a few years and requires a separate analysis.

Chart 8: New Condos See Large Appreciation



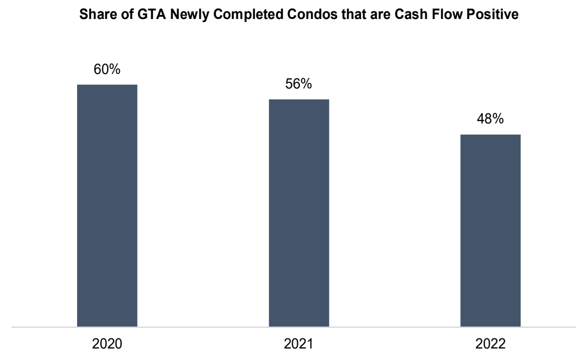
Among newly completed condos used as rentals in 2022, we found that one quarter of investors did not have a mortgage. The rest of our analysis will focus on the remaining three-quarters of mortgaged investments (Chart 9).

Chart 9: Newly Completed Condos by Mortgage Status



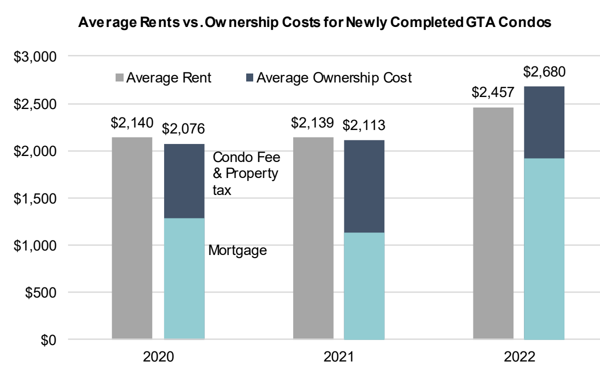
We found that for the first time in 2022, less than half (48%) of leveraged condo investors were cash flow positive, meaning that for the majority, the rent that was generated by newly completed units was lower than mortgage costs (with a typical 20% down payment), condo fees and property taxes (Chart 10). This marks a meaningful shift that may potentially signal that a change in investor behavior is on the horizon.

Chart 10: Fewer Condos are Cash Flow Positive



Breaking things down, we see that positive cash flow was still being achieved for most newly completed condos back in 2021 even with a lack of rent growth that year, as lower interest rates resulted in reduced monthly mortgage payments. While the rental market recovered and rents reached new highs in 2022, that growth was more than offset by rising mortgage costs as interest rates soared, resulting in the average investor of newly completed condos experiencing negative cash flow for the first time (Chart 11).

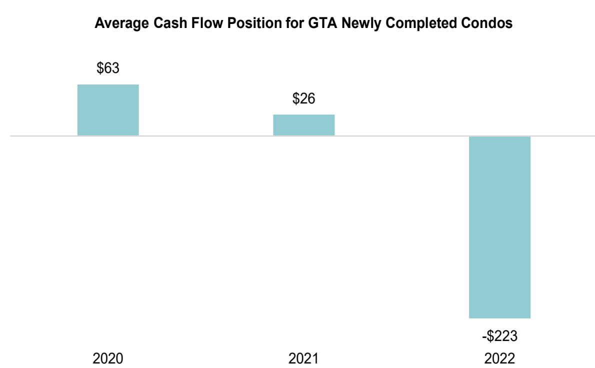
Chart 11: Rent vs. Ownership Cost for New Condos



The shift in cash flow has been rather substantial, moving from a positive average monthly position of $63 in 2020 to a negative average position of

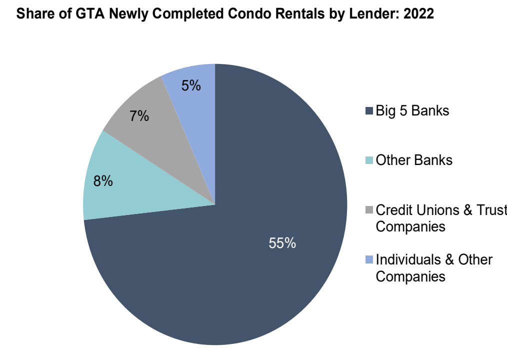
$223 in 2022 (Chart 12). Although based on a smaller sample, the data shows that the negative monthly cash flow position for newly completed condos worsened in Q1-2023 to more than $400. While some of this monthly net loss can be offset by principal repayment, it is unclear how many investors use borrowed down payments that would add to their monthly financial obligations. The concern here is that this change in cash flow could represent a tipping point that causes investors to shorten their holding time and think twice about further investing.

Chart 12: Average Cash Flow Turned Negative in 2022



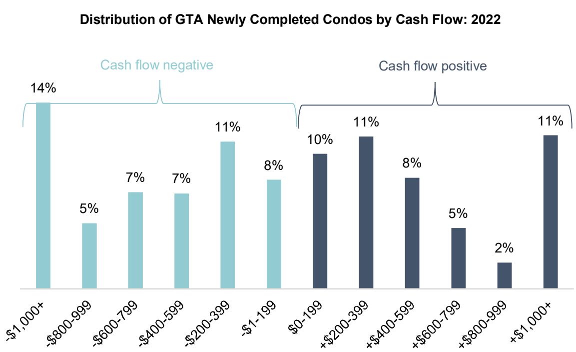
It should be noted that most investors (55%) obtained a mortgage from a Big 5 bank (Chart 13), of which a majority share (53%) were cash flow positive. Negative cash flow was more prevalent in units financed by all other types of lenders. Private individual and company lenders represented 5% of mortgages to investors, but had the highest share of investors (75%) that were cash flow negative.

Chart 13: New Condo Rentals by Type of Lender



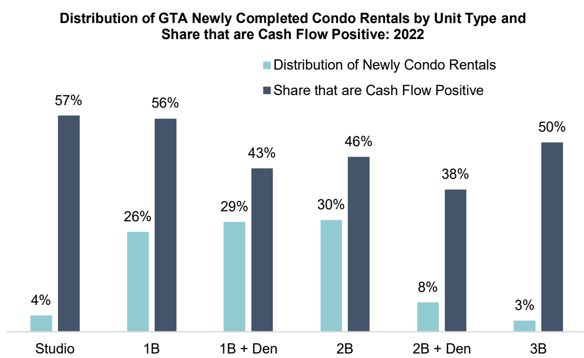
The distribution of newly completed condo rentals by cash flow position shows that the highest concentration (14%) of investors was losing $1,000 or more each month, with a one-third share of investors experiencing negative cash flow of $400 or more. By comparison, a 26% share of investors were able to achieve monthly cash flow of $400 or more (Chart 14).

Chart 14: New Condo Rentals by Cash Flow



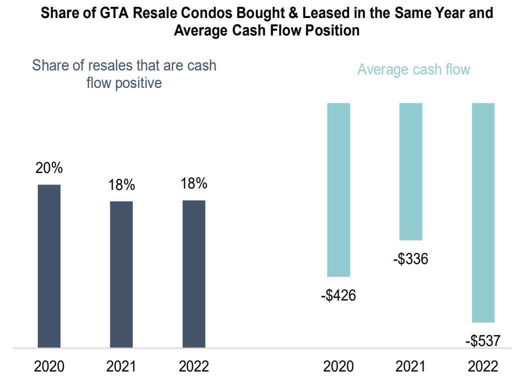
By unit type, one-bedroom condos represented the majority (55%) of condo rental investment units in 2022. While most (56%) one-bedroom-without-dens were cash flow positive, more investors bought one-plus-dens which had a majority share (57%) of units that were cash flow negative (Chart 15). Two-bedroom unit types had a majority share that were cash flow negative, while three-bedroom units were equally split between being cash flow positive and negative. Studios, representing 4% of condo rental investments, had the highest share of units that were cash flow positive (57%).

Chart 15: New Condo Rentals by Unit Type



It has traditionally been much more difficult for investors to buy resale condos and achieve positive cash flow, as they can't take advantage of the very long closing period provided by new condos. In 2022, only 18% of condos bought in the resale market and subsequently rented were cash flow positive, unchanged from 2021 and comparable to 2020 (20%). However, the cash flow position of resale units worsened considerably, averaging a negative monthly amount of $537 — a 60% larger deficit than experienced by resale units bought and leased in 2021. In other words, things are not getting easier in the resale market for investors (Chart 16).

Chart 16: Condo Cash Flow Lower for Resale Units



Concluding Points

• The goal of this analysis was not to make bold predictions about the condo market but instead shed light on a very important shift in condo investment economics that may negatively impact housing supply. With condos representing the majority of new home development and new rental housing, understanding the financial position of condo investors is critical to understanding the housing landscape in the GTA.

• 2022 marked a turning point towards negative cash flow that is expected to worsen in the years ahead as increasingly higher-priced new condos that were presold to investors in the past few years at the market peak reach completion in a higher interest rate environment.

• Some reduction in interest rates and further growth in rents will lighten the impact on investors in the years ahead, but it won't likely be enough to stop their cash flow situation from getting worse.

• A lot depends on the outlook for prices, the credit environment, and the financial wherewithal of investors – if investors are able to access financing, put down more savings against the purchase price and prices are rising, they may be encouraged to hold in the rental market with a long-term view even with negative cash flow experienced at the onset. Condo investors also appear to be adjusting their purchases by shifting into lower priced markets where positive cash flow is more attainable.

• Supply constraints should limit any negative market impact on condo prices – project delivery timelines are being stretched as the development industry faces capacities to deliver no more than just over 20,000 units per year, which results in longer closing periods for investors (and more time for rents and prices to appreciate) and ultimately represents marginal overall supply growth for a condo stock in the GTA that is approaching a half-million units.

• The bigger picture issue is that investors may no longer be able or willing to buy condo presales to the same extent as in the past. This raises the risk of reduced new condo demand, affecting new construction activity, deliveries and, ultimately, rental supply. All of this speaks to the need for more purpose-built rental housing.