GTA Housing—Rent Must be Part of the Solution

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The trajectory of the Greater Toronto Area's (GTA) housing market is not written in stone. It's largely a function of policy. Policymakers are needed because the GTA is not a normally functioning market. Legislation-driven land constraints suggest that we are in a classic case of market failure, in which the invisible hand will not find the optimal path.

So energy should not go into speculating on how bubbly the GTA housing market is, but rather to finding the optimal policy mix to prevent a full-blown affordability crisis. Ottawa's ability to help here is limited since national policies are too blunt to deal effectively with the GTA market. What is needed is GTA-specific policies.

Imposing a foreign buyer tax will work to slow activity at the margin, but should not be seen as the ultimate solution. A much more effective and long-lasting solution would be to dramatically change the role of rental activity in the city's housing mix. Simply put, the propensity to rent in the GTA must rise, and the market should realign to increase the supply of rental units. Crucial here is the role of purpose-built apartment supply. As rents continue to rise, the math for a growing number of purpose-built projects is starting to work. And with some incentives from municipalities, purpose-built rental could be the difference between an affordable and an unaffordable GTA housing market.

Something Happened in 2016

Take a look at Chart 1. Until 2016 the combination of strong demand and lack of supply generated a robust, but relatively predictable path of house price appreciation in the GTA. But the notable hockey stick-like acceleration in house price inflation in 2016 suggests that other forces are at play. The 17.3% increase in average prices in 2016 is by far the strongest we have seen since the late 1980s.

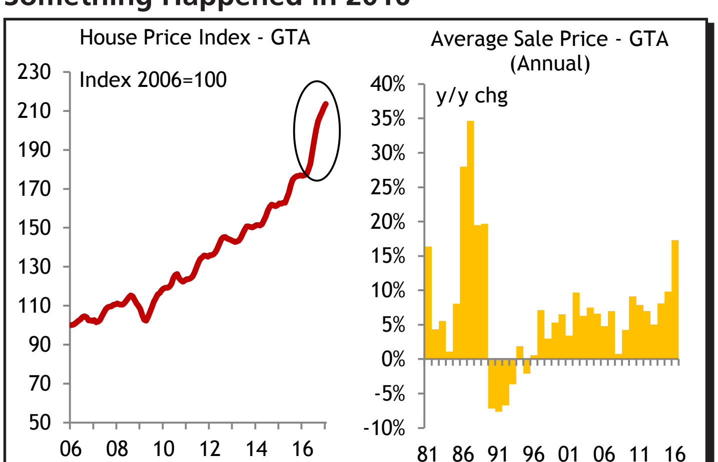
To be sure, the fundamentals for strong price acceleration are still in place. Not only is demand strong, but it's in fact stronger than perceived, as official data underestimate the number of households in the GTA by roughly 60,000 due to clear undercounting of the number of non-permanent residents in the region.

At the same time, land prices for low-rise units continue to accelerate, and the lag factor suggests that there is more to come.

But what was different in 2016 was the notable increase in the price of high-rise units. Condo prices rose by close to 16% (year/year) in the fourth quarter of 2016—the largest gain since the recovery year of 2010, and the rapid acceleration in activity in late 2007 ahead of the introduction of the land transfer tax in Toronto (Chart 2).

Chart 1

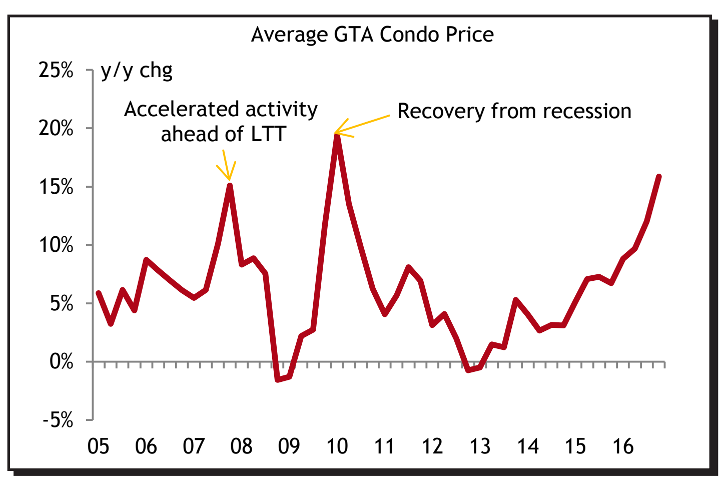
Something Happened in 2016



Source: Teranet/National Bank of Canada, CIBC

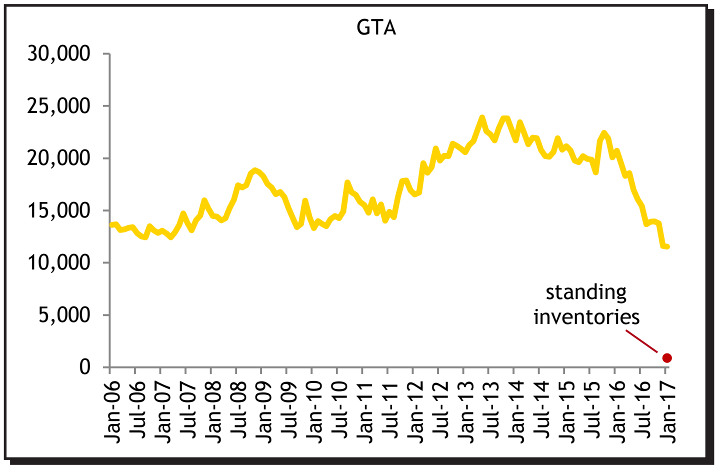
Chart 2

Condo Prices Took Off in 2016



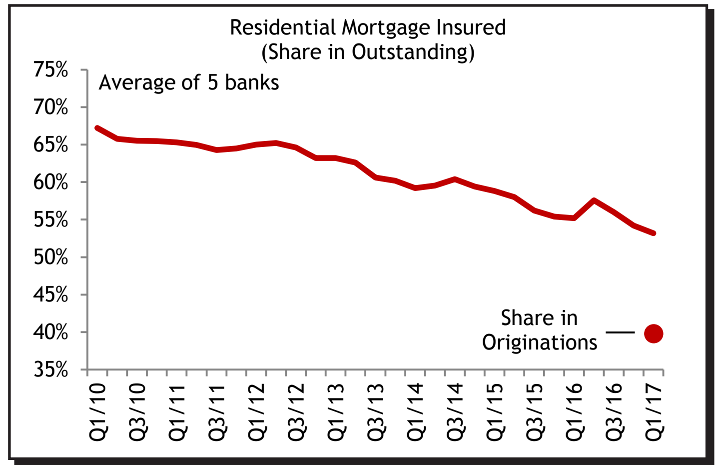
Source: Urbanation, CIBC

Chart 3
Falling Remaining Inventories of High Rise Units



Source: Altus Group, CIBC

Chart 4
Shrinking Target



Source: Company reports, CIBC

And the trigger here appears to be the same as the one that led to the rapid rise in the price of low-rise units—land prices. Land for high-rise projects in the GTA is getting scarcer and scarcer. The low-hanging fruit (mostly parking lots) is no longer available and builders have to be more creative in finding suitable development lots. We asked some of the GTA's largest developers to rank the level of difficulty in finding suitable lots for high-rise projects today, relative to a few years ago. On a scale of one to ten, the average response was eight.

So, as opposed to popular perception, the condo market is actually undersupplied. No less than 27,217 new condo apartments were sold in the GTA in 2016—a record year-over–year growth rate of 34%. But that surge in demand is not being met with a similar increase in supply. The number of new condo launches last year was actually down by 6% and the number of unsold inventories fell by 50% to a 10-year low (Chart 3). The lack of suitable lots in the 416 market is leading to increased condo activity in the 905 market, which in 2017 will probably overtake the former city of Toronto in terms of condo sales.

So there is some logic to the madness, but we still find it hard to fully explain the surge in prices in 2016, just based on those fundamentals. For house prices to rise by close to 20% in one year, there must be a notable increase in speculative and flipping activity contributing to that trend. And that makes it even more urgent for policymakers to intervene.

GTA-specific Policies

Of course policymakers have been intervening. It's too early to assess the effectiveness of the recent round of policy changes introduced by Ottawa in October 2016, but we expect that at the margin they will work to slow mortgage activity. However, the impact will not be dramatic. National policies are very limited in their ability to deal with the GTA's specific issues, and the reality is that all of those changes are aimed at a shrinking target—the insured segment of the market. Today that market accounts for less than 40% of originations by major banks (50% of outstanding)—down from over 60% only a few years ago (Chart 4). At this rate, within 3-4 years the insured market will account for less than 25% of originations—making those government policies even less effective.

So it's clear that what is needed is GTA-specific policies. A good start would be to shelve the proposed amendments to the region's intensification and density targets (see *"The GTA Housing Market: Is There Logic Behind the Madness?"*). Beyond that, while imposing a tax on foreign buyers would work to soften activity, such a tax will not be a game changer. We believe that at this point, the share of pure foreign buying in the GTA is notably lower than its share in Vancouver. Furthermore, even in Vancouver, the softening in activity following the introduction of the 15% tax on foreign buying does not only reflect the direct impact of the tax. Rather, in large part, it reflects reduced activity by domestic buyers as they assess the eventual impact of the tax. When the fog clears it will become evident that the direct impact of the tax was not as significant as perceived and, as activity stabilizes, buyers will return to the market.

The Rental Option

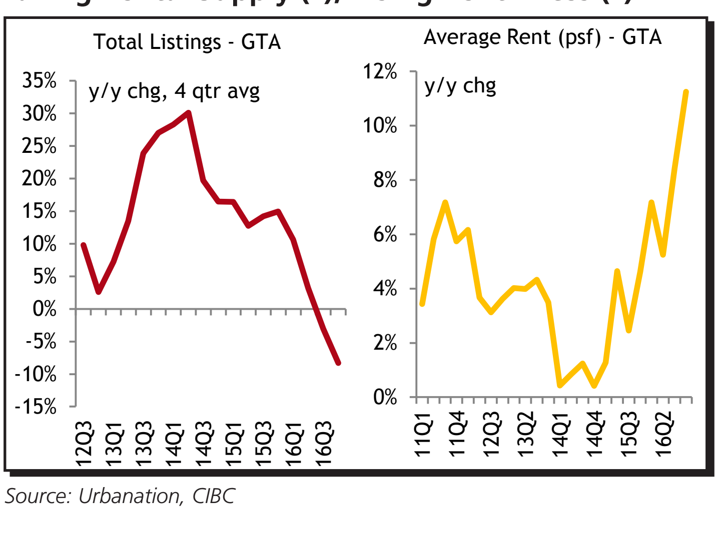
For a real and lasting change, municipalities in the GTA must rethink the role of rental activity in the region's housing mix. There is little doubt that the GTA's rental market has never been hotter. While the number of leases fell by 9% in 2016, that decline reflected reduced supply (Chart 5, left) as opposed to lower demand. In part, that reduced supply reflects a lower turnover rate, with more renters staying put as the cost of venturing back out into the open market has risen notably in recent years. No surprise then that average rent in the GTA has risen by almost 12% in 2016 to a record high of $2.77 psf (Chart 5, right). What's adding to the price pressure is the changing composition of rental activity with a growing share of leases signed in the more expensive segment of the rental spectrum. In 2016 no less than 52% of leases were above the $2.75 psf threshold, up from 25% in 2015. That, along with reduced turnover rates, can be seen as signs of increased acceptance of the rental option by young families.

Purpose-Built

With the propensity and composition of rental activity changing, it's becoming clear that the condo market can no longer be the only option available to renters. The new wave of renters will need the stability of long-term renting and that's where purpose-built developments enter the picture. Only two years ago the number of purpose-built apartments under construction was below 2,000. Today it's above 5,000—accounting for just over 16% of new rental supply. And that number will be much larger in the coming years. As of the fourth quarter of 2016, there were almost 28,000 purpose-built units.

Chart 5

Falling Rental Supply (L), Rising Rent Prices (L)



Source: Urbanation, CIBC

Many of those new developments will go ahead as the math for purpose-built units is starting to work. During the course of our research we obtained a number of pro forma tabulations comparing the profitability of condos vs. purpose-built. We found that in the 416 market, as rent on purpose-built projects can easily reach north of $3 psf, the profitability gap is very narrow. In many cases when the project is being built on surplus land, the decision to favour purpose-built is even easier. What's more, often the developer is a publicly traded company, in which markets attach higher valuations to steady cash flows derived from rent as opposed to a quick one-off profit obtained from a condo project. Also helping here is the increased involvement of institutional investors, such as pension funds in that space, suggesting that a lower yield to cost is accepted.

But for purpose-built developments to really take off and provide the rental solution that the GTA so desperately needs, we will have to see an even larger supply. For that, developers will need some incentives from municipalities.

From conversations with developers it's clear to us that expediting the approval process for purpose-built projects can make a significant difference in the final decision. Municipalities can demand in return, increased inclusion ratios. Other ways to promote purpose-built activity is to offer higher intensification rates for purpose-built developments, cut the HST charged on the development, as well as eliminate or reduce development charges, as today the same charge is imposed on both condo and purpose-built projects.

The GTA market is fast approaching a full-blown affordability crisis. The market will eventually be tested when interest rates rise and/or the economy faces its next recession. What we do between now and then will determine the ability of the region to face that test. Increased rental propensity and supply of purpose-built apartments must be part of the solution. Policymakers can make a difference here.