

Rental Market Opportunities in the City of Toronto

Implications for Assisted Housing Programs

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For:

Greater Toronto Apartment Association

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Table of Contents

	Page
Introduction	2
Summary of Findings	3
About Will Dunning and Will Dunning Inc.	5
Conditions in the Rental Apartment Market	6
Rent Trends	7
Vacancy Rates by Rent Range	8
Rental Apartment Outlook	10
Market Factors	10
Looking Forward	12
Development Costs for Apartments	15
Housing Need in the City of Toronto	18
Financial Analysis of Two Program Alternatives	20
Cost for the Affordable Housing Program	20
Cost for Rent Supplements	21
Market Impacts of Rent Subsidies	21
Conclusion	22
Details of Financial Analysis	24

Tables		
Table #	Title	Page
1	City of Toronto Proposed Housing Initiatives	2
2	2 Program Options for Reducing Rents to 80% Below Average, Cost Calculated Over a 25-Year Period	4
3	City of Toronto Average Rents for Privately-Initiated Apartments, by Bedroom Type	8
4	Vacancy Rates by Rent Range and Bedroom Type in the City of Toronto, October 2007	9
5	Summary of Factors Affecting the Toronto CMA Vacancy Rate	13
6	Core Housing Need in Ontario, in 2001, By Age Group	19
7	2 Program Options for Reducing Rents to 80% Below Average, Costs Calculated Over a 25-Year Period	23
8	Subsidy Costs for the Affordable Housing Program	24
9	Subsidy Costs for Rent Supplements, Based on Current Market Rents	25
10	Subsidy Costs for the Rent Supplements, Assuming Contracted Rents 5% Below Market Average	26

Introduction

This report has been prepared by Will Dunning Inc. at the request of the Greater Toronto Apartment Association. It reviews the current state of the rental apartment market in the Toronto area and its outlook to 2010. It also estimates the costs of providing rent supplements for low income households, in comparison to subsidy costs for the creation of new rental units under the *Affordable Housing Program*.

The City of Toronto is currently engaged in a consultation process on housing strategies for 2008-2018. As part of this, it has established several targets to meet housing needs, with the intention of “focusing the action to be undertaken by governments, the non-profit and private sectors and the public, and to measure results”. Targets are aligned along six strategic themes, and annual costs are estimated. As is shown in the table below, the City estimates that this very ambitious set of targets will have a cost of \$469 million per year over a 10-year period.

There is some ambiguity in the targets: while targets are set for the total number of households assisted, it is not clear how many households will be receiving assistance at any given time. For example, while there is a target to assist 60,000 households to afford rents (the second initiative), this could mean that 60,000 households would be assisted every year, or 6,000 households per year, or somewhere in between; for the option to create new rental housing, the objective is to assist 11,000 households over a 10-year period, but it is unclear how many actual units would be created¹.

<i>Theme</i>	<i>Proposed Initiatives</i>	<i>Households Assisted over 10 Years</i>	<i>Estimated Annual Investment</i>
Help homeless and vulnerable people find and keep homes	Preserve existing single room buildings, hostel to homes initiative, supports to “Streets to Homes” tenants, create new supportive housing, eviction prevention and housing help	13,000	\$46 million
Assist people to afford rents	Expanded rent supplement and housing allowance initiatives	60,000	\$120 million
Preserve and fix rental housing and keep it affordable	TCHC repair backlog, increase non-profit and co-op reserves, repair and energy retrofit private rental housing	115,000	\$89 million
Create and renew mixed, inclusive, sustainable neighbourhoods	TCHC asset regeneration, mixed communities in downtown waterfront, non-profit and co-op intensification, redevelop some shelter sites	10,000	\$100 million
Create new rental housing	Continue and expand current affordable housing program	11,000	\$110 million
Help people to buy and stay in their own homes	Down payment and rehabilitation assistance and price and re-sale controls related to planning approvals	10,000	\$4 million
Total		209,000	\$469 million

Source: City of Toronto, “Housing Opportunities Toronto

¹ This ambiguity makes it impossible to meaningfully compare the targets, or to use the cost estimates provided to compare the cost effectiveness of the various options.

Summary of Findings

At present, about 8,500 rental apartments are vacant within the City of Toronto. The vacancy rate is forecast to remain high, and possibly increase further during the next three years. This increase will be due largely to the very high volumes of new condominium and rental apartments that will be completed during the period, which will draw tenants out of the rental market. During 2009 and 2010 there would be 10,000 or more vacant rental apartment units in the City.

Vacancies are widely distributed across the City and there are considerable vacancy rates at all rent levels. In particular, vacancy rates are elevated for units with below average rents.

The City of Toronto has an objective to expand the supply of affordable rental units, by about 1,000 units per year. The units would be subsidized through the federal/provincial/municipal *Affordable Housing Program* and would have rents equal to about 80% of average. The subsidy cost (federal and provincial contributions) would be \$70,000 per unit; municipal contributions would take the form of waiving various fees and taxes. While the value of these cost reductions can be calculated, it appears that little if any actual municipal expenditure will occur.

Given the current and anticipated levels of vacancies, there is not a pressing need to expand the rental supply, as many rental opportunities already exist at the level (80% of average) that is proposed for the new program. Moreover, for available units with rents above that 80% threshold, rent supplements could be used to augment the supply of units at the 80% threshold.

Financial analysis developed in this report contrasts the costs of creating new units at the 80% threshold via the *Affordable Housing Program*, versus through rent supplements within existing housing². For the rent supplement approach, two scenarios are analyzed. Results of the financial analyses are summarized in the following table. It shows that:

- In the first scenario, it is assumed that rents contracted under the program are at current average market rents (which then increase by 2% per year), and subsidies are used to reduce the tenants' costs to 80% of the market average rent. In this scenario, the cost of a rent supplement approach is similar to the cost of achieving the same results through the *Affordable Housing Program* – on an actual cost basis, the cost of rent supplements is slightly higher (8%) than the cost under the *Affordable Housing Program*; on a net present value basis³, rent supplements are less costly (by 17%) than the *Affordable Housing Program*.
- However, if a competitive tendering process results in contracted rents that are 5% below the market average – which is a highly possible outcome, given current and expected market conditions – then the costs of rent supplements are substantially

² This analysis focuses on an outcome in which the assisted tenants pay rents equal to 80% of the average rent in the market. Many other outcomes are of course possible, including much deeper subsidies for households with very low incomes. However, the incremental costs of achieving these alternative outcomes should be the same for either approach (providing deeper rent supplements for newly constructed units or for existing housing). Therefore, to keep the discussion relatively simple, those alternative outcomes have not been analyzed.

³ Net present value is calculated using a discount rate of 4%.

lower than the costs under the *Affordable Housing Program*: on an actual cost basis the rent supplement approach has an estimated cost 19% less than the *Affordable Housing Program* and on a net present value basis the cost is 38% less. Looking at the lower right corner of the following table, which shows a 38% reduction in costs compared to a new construction approach – for a given amount of subsidy dollars, the City would be able to assist about 50% more needy households if it used a rent supplement approach rather than new construction subsidies.

- Moreover, if rent supplements are provided *in situ* (for tenants in their existing situations), many of those tenants will be paying rents that are 5%, or even more, below the market-wide average. Therefore, this second scenario of rents 5% below average is far from fanciful and in fact there will be many situations in which the costs for rent supplements are even less than in this second scenario, and the cost savings resulting from rent supplements will be even larger than this analysis indicates.

Option	Calculated Costs		% Difference Versus Affordable Housing Program	
	Actual Cost	Net Present Value	Actual Cost	Net Present Value
Affordable Housing Program	\$70,000	\$57,271		
Rent Supplements (with 2 scenarios)				
Based on Current Market Rents	\$75,719	\$47,275	8%	-17%
Contracted Rents 5% Below Market Average	\$56,789	\$35,457	-19%	-38%

Source: Estimates by Will Dunning Inc.

There are additional considerations:

- There is uncertainty about the actual costs of new development under the *Affordable Housing Program*, because development costs for apartments have increased rapidly, and are continuing to increase. It is possible that projects that have already been committed will require further subsidies beyond the \$70,000 figure. It is also possible that in future there will be increases in the required amounts of subsidies.
- During the past five years the average rent in the City of Toronto has increased by only 0.2% per year. Continued slow growth in rents may cause rental revenues of *Affordable Housing Program* projects to fall short of expectations, resulting in a need for future operating subsidies.
- The analysis assumes that *Affordable Housing Program* projects will not require any re-investment. Over a 25-year horizon, that is a strong assumption, and needs for re-investment may necessitate additional subsidies.
- Use of a rent supplement approach would give the City flexibility to provide partial subsidies (rather than reducing rents to the point at which they are equal to 30% of income, in some circumstances the affordability gap could be partially reduced – for the households assisted, a partial subsidy will be better than no subsidy). This would allow the City to stretch the available dollars further.

Thus, there are upside risks for the subsidy costs under the *Affordable Housing Program*. On the other hand, for the rent supplement approach, these risks would be

borne by property owners. The City (as well as the federal and provincial governments) would not be exposed to these risks under a rent supplement approach.

Yet another consideration is that commitments under a rent supplement program can be made for relatively short periods of time (say, 5 years). This will enable the City to take full advantage of current slack conditions in the rental market, as well as to avoid subsidizing new construction at a time when development costs (and therefore the associated subsidy requirements for the *Affordable Housing Program*) are very high. Should these market conditions change in the coming years, and shift the financial balance in favour of new development, then the City would have flexibility to shift funding away from rent supplements.

A final consideration is that providing rent supplements within the existing stock of housing will, to some extent, stimulate new demand for rentals, which would contribute to lower vacancies and may result in rents increasing more rapidly than they might otherwise, thereby increasing the costs of rent supplements. This indicates that a comprehensive program response ought to include some expansion of the rental inventory, in addition to the rent supplements. The consultation paper from the City of Toronto, with its proposed mix of options, indicates that about 6 rent supplement opportunities will be created (within the existing housing stock) for every one unit that is newly built via the *Affordable Housing Program*. This ratio appears to be about right, and should be sufficient to offset any demand that is stimulated by the rent supplements.

In conclusion, utilizing a rent supplement approach, the City would be able to provide financial assistance to tenants within their current dwellings. For the tenants, this would eliminate the expense, inconvenience, and disruption of moving. From the perspective of the City, it would reduce the cost of assisting tenants and it would avoid the financial risks associated with the construction of new rental housing – risks that are clearly very high at this time.

About Will Dunning and Will Dunning Inc.

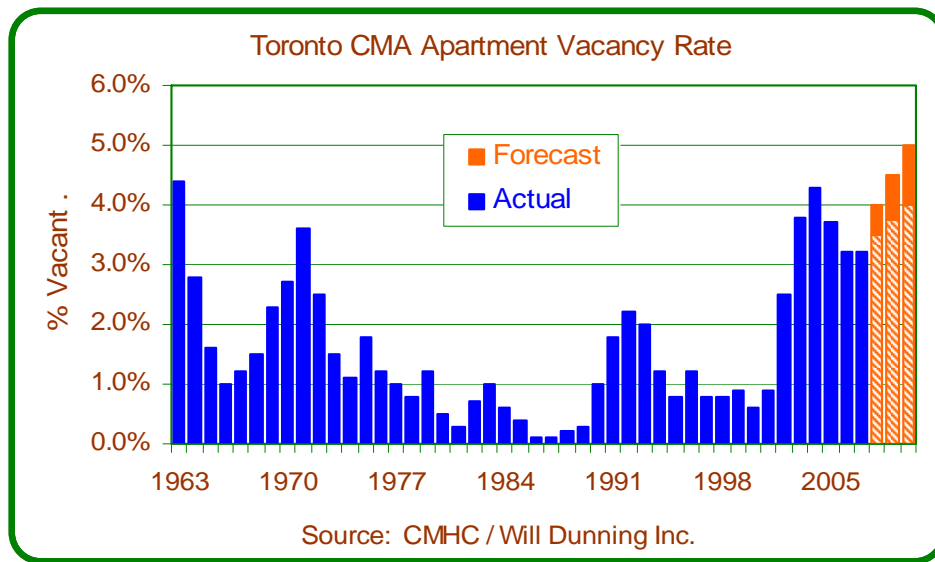
Will Dunning Inc. is an economic research firm. Based in Toronto, the firm specializes in housing market analysis, including project-specific market feasibility studies and expert witness testimony. The firm is led by Will Dunning, who has been analyzing housing markets since 1982. Following 16 years with the federal housing agency (Canada Mortgage and Housing Corporation), Will joined a real estate consulting firm in 1997, where he was second-in-command. In September 2000, he established his own firm. Will has completed several hundred consulting studies, including economic analysis and forecasting studies as well as feasibility studies for proposed residential developments. He is frequently quoted in the news media on the housing market and speaks to industry forums, associations, and other interest groups. His website www.wdunning.com provides a variety of reports and presentations, including Housing Market Digest, a monthly review of the housing market in the Greater Toronto Area.

Conditions in the Rental Apartment Market

Beginning in 2002, the residential rental market in the Toronto area has entered an era of high vacancies. As is illustrated in the following chart, since the mid-1970s until early in this decade, vacancy rates in the Toronto CMA had been less than 2% almost all of the time and were usually in the area of 1% or less. During 1973 to 2001, the vacancy rate averaged just 0.9%.

However, the vacancy rate began to climb in 2002, reaching 2.5% by that October. Further increases occurred as of October 2003 (to 3.8%) and October 2004 (4.3%). The October 2004 vacancy rates was just fractionally lower than the 4.4% record set in 1963. The vacancy rate fell in both 2005 (to 3.7%) and 2006 (to 3.2%), and stayed at 3.2% as of October 2007. While the vacancy rate is below its peak level, it remains well above the low levels seen prior to 2002.

As is shown in the chart (and is discussed in more detail in a later section) I forecast that the vacancy rate will climb further, to a range of 3.5% to 4.0% in 2008, 3.75% to 4.5% in 2009, and 4.0% to 5.0% in 2010.



The City of Toronto has seen a similar change in vacancy rates. In October 2001, the vacancy rate in the City was 0.9%. In subsequent Octobers the apartment vacancy rates were:

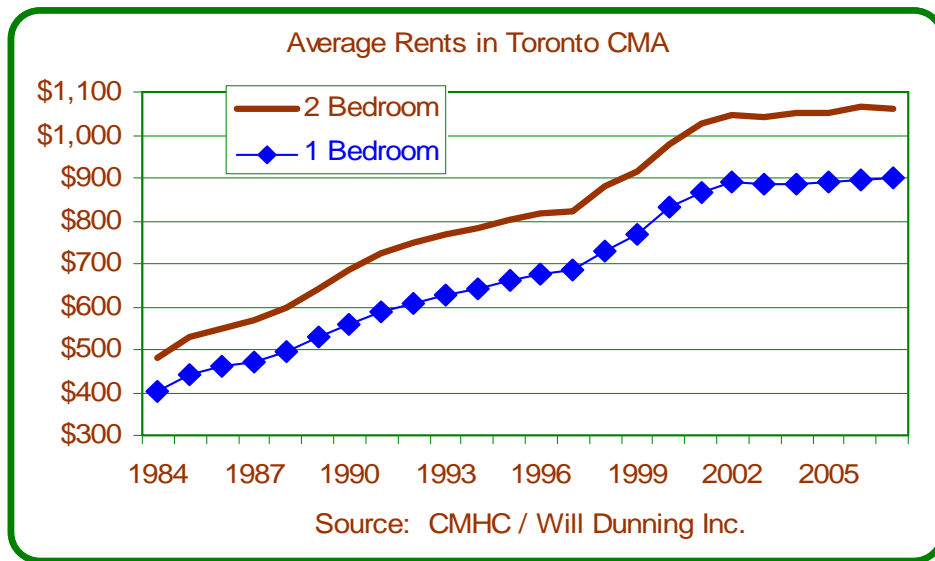
- 2002 – 2.4%,
- 2003 – 3.9%,
- 2004 – 4.3%,
- 2005 – 3.7%,
- 2006 – 3.3%, and
- 2007 – 3.4%.

The City's vacancy rate for October 2007 represents 8,553 vacant units.

Recently, CMHC has added a supplementary measure of “availability” – units for which the existing tenant has given, or has received, notice to move, and a new tenant has not signed a lease; or the unit is vacant. As of October 2007, the availability rate is 5.0% for the Toronto CMA and 5.2% for the City of Toronto. The availability rate for the City of Toronto corresponds to about 13,000 units.

Rent Trends

The expansion of rental vacancies has resulted in a sharp slowdown in the rate of rent increases in the Toronto area. As shown in the following chart, rents in the Toronto CMA have increased quite slowly during the past five years - by only about 1% in total during the five years from October 2002 to October 2007, or only about 0.2% per year.



By contrast, the overall inflation rate (for the Toronto CMA) was 9.6% in total over the same period, or an average of 1.9% per year. In economists’ terms, it can be said that rents fell in “real (inflation-adjusted) terms”. Rents have also increased much less rapidly than incomes. For all of Ontario, the average weekly wage increased by 11.0% over the same period, or 2.1% per year.

Similarly, as can be seen in the next table, for the City of Toronto, the average rent increased by only about 1% in total during 2002 to 2007, or an average rate of 0.2% per year.

Table 3
City of Toronto Average Rents
for Privately-Initiated Apartments, by Bedroom Type

October of	Bach.	1 BR	2 BR	3+ BR	All Types
2002	\$733	\$894	\$1,055	\$1,279	\$976
2003	\$734	\$884	\$1,045	\$1,225	\$961
2004	\$730	\$888	\$1,061	\$1,258	\$973
2005	\$726	\$889	\$1,060	\$1,265	\$972
2006	\$743	\$897	\$1,078	\$1,296	\$990
2007	\$742	\$902	\$1,072	\$1,275	\$985
% Change 2002-2007	1.2%	0.9%	1.6%	-0.3%	0.9%
Annualized	0.2%	0.2%	0.3%	-0.1%	0.2%

Source: CMHC; calculations by Will Dunning Inc.

Vacancy Rates by Rent Range

The following table provides CMHC data on vacancy rates in the City of Toronto by rent range, as of October 2007. The second last row in the table also shows the average rent for each of the four unit types and the last row shows rents 20% below average, which is the target for the *Affordable Housing Program*.

The table shows that for each bedroom type, vacancies are widely distributed across the rent ranges. However, vacancy rates tend to be higher at below-average rents than for above average-rents - for each unit type the rent range that includes the average rent has a significant vacancy rate and vacancy rates are also high in the next lower rent range:

- For bachelor units (average rent of \$742): the \$700-\$799 rent range has a vacancy rate of 2.4%; the less than \$700 range has a vacancy rate of 5.0%.
- For one bedroom units (average rent of \$902): the \$800-\$899 rent range has a vacancy rate of 4.2%; the \$700-\$799 range has a vacancy rate of 5.2%.
- For two bedroom units (average rent of \$1,072): the \$1,000-\$1,099 rent range has a vacancy rate of 2.8%; the \$800-\$899 and \$900-\$999 ranges have vacancy rates of about 5%.
- For apartments with three of more bedrooms (average rent of \$1,275): the \$1,100-\$1,299 rent range has a vacancy rate of 2.8%; the \$1,100-\$1,199 range has a vacancy rate of 10.3%.

In conclusion, this data from CMHC indicates that in the City of Toronto, there are substantial numbers of vacancies at or below the average rent for each unit type. The *Affordable Housing Program* aims to create new rental units with rents 20% below market averages. The data that is available is too blunt to show how many units are available in the market at 20% (or more) below average rents. However, the available data does suggest that there is a considerable amount of choice available at the rent thresholds that are targeted by the *Affordable Housing Program*.



Table 4				
Vacancy Rates by Rent Range and Bedroom Type in the City of Toronto, October 2007				
<i>Rent Range</i>	<i>Bachelor</i>	<i>One Bedroom</i>	<i>Two Bedroom</i>	<i>Three or More Bedrooms</i>
Less than \$700	5.0%	**	1.9%	1.2%
\$700-\$799	2.4%	5.2%	4.3%	0.0%
\$800-\$899	1.8%	4.2%	5.1%	1.4%
\$900-\$999	1.0%	2.6%	5.0%	**
\$1,000-\$1,099	0.6%	1.2%	2.8%	10.3%
\$1,100 and over	1.2%	1.6%	2.1%	2.8%
Average Rent	\$742	\$902	\$1,072	\$1,275
20% Below Average (Target for Affordable Housing Program)	\$594	\$722	\$858	\$1,020
Source: CMHC				
Note: ** indicates that data not available or suppressed by CMHC				

Rental Apartment Outlook

From the low rate of just 0.9% in 2001, the vacancy rate in the Toronto CMA began a very rapid ascent in 2002 (2.5%) and 2003 (3.8%). The vacancy rate peaked in 2004 at 4.3%, and then eased in 2005 (3.7%) and 2006 (3.2%). The rate was remained at 3.2% in 2007.

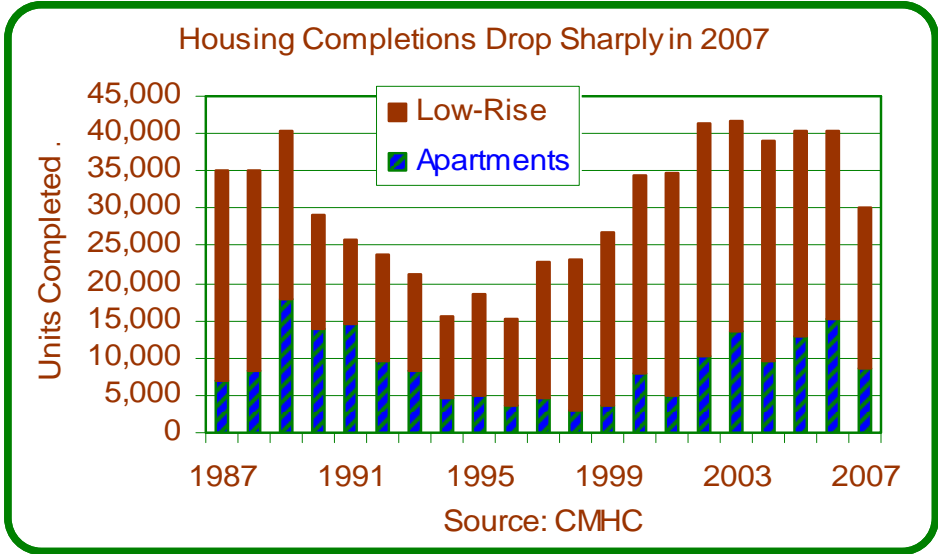
Market Factors

Factors that affect vacancy rates include:

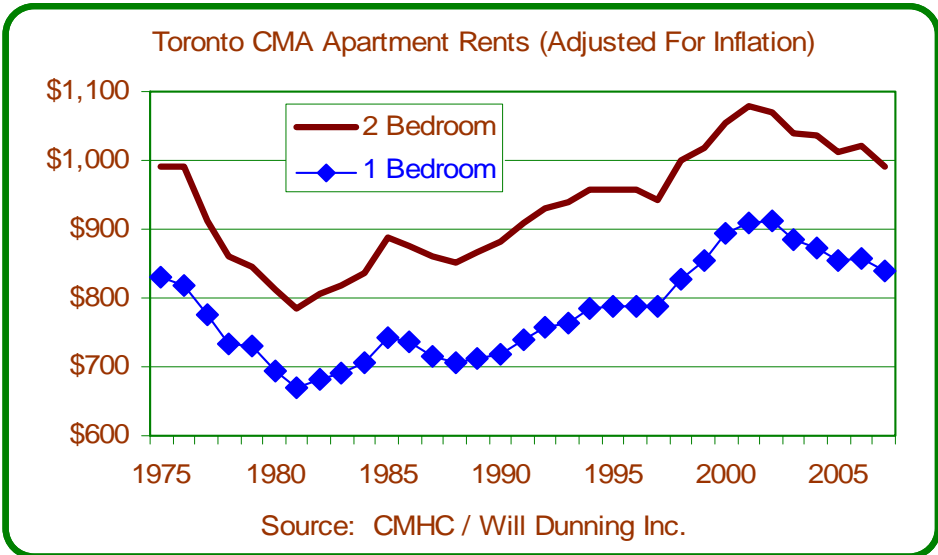
- Growth of employment – job creation stimulates the formation of new households and thereby tends to reduce the number of vacant units.
- Competition from home ownership – an increase in home buying activity increases the number of people who move out of rentals and thereby tends to increase the number of vacant units.
- New rental supplies – an expansion of supply tends to increase the number of vacant units.
- Rent levels – higher rents (especially relative to the cost of home ownership) tend to reduce the demand for rentals and thereby increase the vacancy rate; conversely, lower rents stimulate demand and tend to reduce vacancies.

The higher vacancy rates seen in recent years have been due to a combination of these factors:

- Employment growth has slowed in the Toronto CMA. During 1995 to 2001, growth averaged 3.3% per year; during 2001 to 2007 it averaged 2.0% per year. This slowing was initially due to the bursting of the stock market bubble (in 2001) and more recently due to the strengthening of the Canadian dollar relative to the US dollar as well as the rise in prices for energy and other commodities.
- The slowdown in job creation reduced the rate at which new households were being formed and therefore there was less movement into rentals.
- Meanwhile, an increase in housing completions meant that more people were moving out of rentals. The following chart shows annual housing completions (for 12-month periods ending in September of each year, to correspond with the October rental market survey). It shows a rising level of completions that began in 1999 and became quite elevated in 2002 and 2003, which coincides with the most rapid increases in the vacancy rate. The number of completions remained high during 2002 to 2006, but fell sharply in 2007. The largest drop in 2007 was for apartments – while a very substantial volume of projects is under construction, delays in construction have prevented projects from reaching completion. If projects had proceeded to completion in a more timely manner, the vacancy rate would most likely have increased in 2007.
- During the past six years, over 900 new rental units have been completed per year, which has further contributed to the rise in vacancies.



- Rents increased rapidly in the late 1990s, due to the introduction of vacancy decontrol in June 1998, but also due to catch-ups for allowable rent increases that were not taken earlier in the decade. The following chart shows average rents for 1 and 2 bedroom apartments, after adjustment for inflation. It indicates that rents increased rapidly in “real terms” during 1997 to 2001, but fell back during 2002 to 2007. At present, inflation-adjusted rents are higher than they were before 1998. The recent reduction of rents in “real terms” has tended to increase demand for rentals, which offsets the other factors to some degree.



This review indicates that during the past six years the factors that affect vacancies have mostly lined up on the side of increasing vacancies. However, during 2005 and 2006, the vacancy rate actually fell, contrary to those indicators. Those drops are difficult to explain with reference to the measurable indicators. A possible “unmeasurable” factor that may have stimulated demand for rentals is that property owners have:

- Improved their properties – making significant investments in suite interiors, common areas, building exteriors, and grounds.
- Improved their marketing and management – this includes doing more advertising and raising the professionalism and responsiveness of their on-site staff.

Looking Forward

The factors that have resulted in elevated vacancy rates during the past half decade will continue to influence the Toronto CMA apartment rental market for the next few years.

- Employment growth has decelerated. With the appreciation of the Canadian dollar since the beginning of 2003, key export-oriented sectors of the Toronto CMA economy are showing increasing negative effects. Due to the composition of the local economy, the Toronto area is showing a weak job creation performance. While Canada as a whole has a record low unemployment rate, and the percentage of Canadian adults who are employed is at a record high, those indicators are weakening in the Toronto area. This weakness in the Toronto area is likely to persist, or even become worse. This is a negative factor for rental demand and will tend to increase vacancy rates.
- Interest rates remain relatively low, which continues to stimulate home buying activity, causing thousands of tenants to leave the rental sector. It is likely that slower employment growth will result in some slowing of home buying activity during the coming two or three years. As slower sales convert to reduced construction, there would be reduced movements out of rentals. However, because there are long lags between the date of housing sales and the actual completion of new homes, it will be some time before that slowdown in sales will start to exert downward pressure on the vacancy rate.
- Sales of new low-rise homes are generally-speaking in a declining cycle, following a peak in early 2002. However, sales did stabilize during 2006 until late in 2007. Therefore, completions of new low-rise homes (and the related moves out of rentals) should be sustained at current levels during 2008. During the past few months, the rate of sales has fallen. If this slowing is sustained (and the current forecast by this author indicates that it will be), it would result in reduced housing completions during 2009 and 2010, and correspondingly fewer moves out of rentals. This factor would tend to increase demand for rentals. This positive effect on rental demand might be felt in the “905” areas before the “416” areas.
- However, low-rise activity is less important for the rental market than is condominium apartment activity. In that arena, sales remain very strong. Based on projects that are already under construction (over 26,000 units at the end of September and even more – 27,000 units – at year end 2007), as well as projects that are anticipated to start construction, completions of condominium apartments will remain very strong for the next three years.
 - A significant share of these future supplies of condominiums has been purchased by investors and will be made available for rent, thereby competing directly with the existing rental inventory.
 - At the same time, for the apartments that will be occupied by their owners, most of the future occupants will have made a “substitution” from rental housing

(they will either move out of a rental, or on forming a new household, they will move into ownership rather than into rental tenure).

- Therefore, whether the future condominiums are occupied as rentals or by owners, they will reduce the demand for traditional rentals, and the future supply of new condominiums will tend to increase the vacancy rate.
- A moderate amount of purpose built new rental supply will enter the market during the next two years, as 2,940 apartment units and 9 row units were under construction at the end of September 2007 (these figures are for the Toronto CMA – about three-quarters of the activity is located within the City of Toronto). Despite the high vacancy rates and soft rents of the past five years, investors continue to develop new rental projects, as low interest rates have significantly improved the economic feasibility of new investment. It should be expected that further private sector investments will be made in the coming years. In addition, the federal/provincial/municipal *Affordable Housing Program* will result in further construction of new rentals.
- Continued high vacancies can be expected to result in a continuation of limited rent increases, with the result that rent will continue to fall in real terms. This factor will tend to increase rental demand.

The following table summarizes the key factors that have affected the vacancy rate during the past three years and will affect it over the mid-term.

<i>Factor</i>	<i>Impact on Vacancy Rate During 2001 to 2007</i>	<i>Expected Impacted on Vacancy Rate During 2008-2010</i>
Employment Growth	Increase, due to slower job creation, which results in reduced household formation	Increase, due to continued slow job creation.
Competition from Home Ownership – Low-Rise	Increase	Reduce, due to an evolving slowdown of sales which is resulting in a slowdown of housing completions
Competition from Home Ownership – High-Rise	Increase (although the effect moderated during 2006 and 2007 due to delayed completions)	Strong increase until at least late 2010. While sales of new condominiums are forecast to slow, construction completions will remain very high.
New Rental Supply	Moderate increase from purpose built rentals Significant increase due to investor-owned condominiums	Moderate increase from purpose built rentals, including <i>Affordable Housing Program</i> developments. Significant increase due to investor-owned condominiums. This effect is unlikely to moderate until 2010 at best
Rent Increases	Increase – slow growth of rents appears to have stimulated new demand for rentals	Increase – rents expected to fall further “in real terms”, contributing to demand and partially offsetting other factors

Source: Will Dunning Inc.

Considering all of these factors, I forecast the vacancy rate for Toronto CMA as follows:

- October 2007 – 3.2% (actual)
- October 2008 – 3.5% to 4.0%
- October 2009 – 3.75% to 4.5%



- October 2010 – 4.0% to 5.0%

CMHC has forecast a Toronto CMA vacancy rate of 3.5% for October 2008, but has not published forecasts for subsequent years. While CMHC's forecast differs from mine in terms of the rate expected, it is also indicating that the vacancy rate should rise.

As of October 2007, CMHC reported that there were about 8,500 vacant rental apartments in the City of Toronto (in privately-initiated rental apartment buildings with three or more units). With the anticipated increases in vacancy rates, there would be 9,000 or more vacant apartment units in October 2008, and 10,000 or more vacancies in 2009 and 2010.

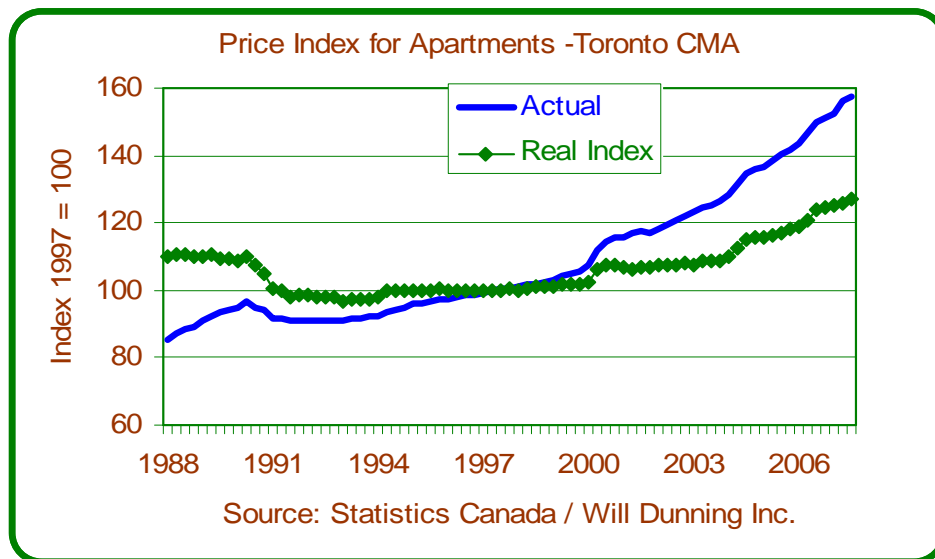
Development Costs for Apartments

Statistics Canada generates estimates of contractors selling prices for apartment construction, for various construction trades⁴ – in other words, it estimates cost trends for some of the major components of apartment construction.

For the Toronto CMA, the index is available from the beginning of 1988 up to the third quarter of 2006. The following chart shows the data for the Toronto CMA. In addition to showing the actual figures, the chart shows the index after adjustment for overall inflation (in other words, in “real terms”).

The index increased slowly during the 1990s (being essentially flat in “real terms”) but then began to increase very rapidly early in this decade (increasing rapidly in “real terms”):

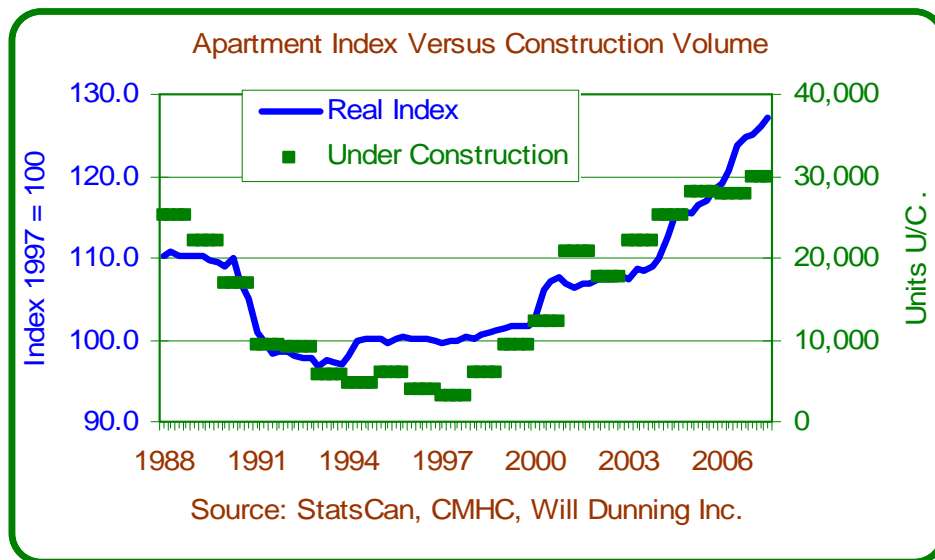
- From the first quarter of 2000 to the third quarter of 2007, the index for Toronto CMA rose by 46.1%, or an average annualized rate of 5.2%.
- By contrast, overall inflation was 18% over the same period (an average of 2.2% per year).
- Therefore, in real terms the apartment price index rose by 23.8%.
- As can be seen in the chart, the index has been at record levels (in real terms) for the past 3.5 years, and is now 15% above the level seen during the overheated market of the late 1980s.



The rapid increase of construction costs for apartments can be easily explained as the consequence of international, national, and local factors that have driven up the costs of major materials used in apartment construction, the costs to lease or purchase equipment, and wages paid for construction labour.

⁴ The trades included in the index are grouped as: structural trades, architectural trades, mechanical trades, and electrical trades.

- Rapid growth of investment in infrastructure around the world (especially in emerging economies) has created demand and resulted in rapid price increases for structural materials and construction equipment.
- Throughout Canada, activity has expanded for residential and non-residential construction, resulting in labour shortages – the high mobility of construction workers has caused wage rates to be bid up.
- In Toronto, record levels of apartment construction have caused the demand for key construction trades to exceed the supply, resulting in construction delays and, as seen above, the rapid bid-up of contractors' selling prices. The following chart contrasts the apartment price index with the volumes of apartments that are under construction in the Toronto CMA. It is clear in the chart that the price increases seen during this decade are associated with very high volumes of construction activity (almost 30,000 apartment units were under construction at the end of 2007).



The level of apartment construction activity can be expected to stay at current levels for the next three years at least, because of record high levels of sales of new condominium apartments, or could even increase. During 2006 and 2007, construction starts fell far short of sales of new condominium apartments. Two implications are that the construction industry has reached its capacity and, secondly, that sales that have already been made (as well as future sales) will result in continued high levels of apartment starts during 2008 and 2009, and possibly beyond.

In this environment, construction costs for apartments can be expected to remain very high, and possibly increase further.

In terms of development of new assisted housing, there are clear risks that rising construction costs will result in further increases in subsidy requirements under the *Affordable Housing Program*.



- It is quite possible that for projects that have already received funding commitments, rising construction costs will mean that they will require increased assistance to cover unplanned and unexpected cost increases.
- For future commitments, it is likely that the starting subsidy requirements will rise, with, once again, the risk that increases will be required after commitments.

Housing Need in the City of Toronto

Within the City of Toronto there are currently 49,748 households on the active waiting list for housing assistance⁵. These households include a total of 128,666 people, or 5.1% of the total population of the City of Toronto.

Despite the improvements in the Toronto rental market, the number of households on the waiting list is essentially unchanged - at the end of 2003, there were 50,218 households on the active waiting list.

Another perspective on housing need uses data from the Census. As of 2001:

- Within the City of Toronto, there were 459,750 tenant households.
- Of these, almost 200,000 (198,470) paid 30% or more of their income for rent.
- This means that 43% of Toronto tenants paid 30% or more of their income for rent.

A third perspective uses the concept of “core housing need”, which has been developed by Canada Mortgage and Housing Corporation. In 2001, 15.1% of all households in Ontario were in core need⁶. This includes 7.3% of home owners and 32.3% of tenants. These figures for Ontario imply that in the City of Toronto about 175,000 to 200,000 households are in core need. This would include 35,000 to 40,000 homeowners and 140,000 to 160,000 tenants.

Data on core housing need for Ontario (as of 2001) has been examined further. As shown in the following table:

- About 600,000 households in Ontario are in core housing need, which represents 15.1% of all households.
- By age group, the highest rates of need are found for the youngest (15 to 24 years) and oldest (75 years and older).
- The affordability gap (the difference between what these core need households can afford to pay for housing (based on 30% of their income) versus the cost of suitable housing in their communities) is \$457 per month. In aggregate, the affordability gap for Ontario is \$3.3 billion per year. If these factors also applied to the City of Toronto, the total affordability gap would be about \$1.0 billion per year. This represents the theoretic cost (as of 2001) of addressing all core housing need problems within the City. The cost today might not be very different, or might be slightly lower, because of the slow rate of increase in rents that has been seen during the past five years.

Core housing need estimates will be generated from the 2006 Census, although results will not be available for some time yet. It is likely that the percentage of tenants in core need will fall compared to 2001, due to the slow rate of rent increases since 2002.

⁵ Source: Housing Connections report, 4th Quarter 2007.

⁶ Source: “Dimensions of Core Housing Need in Canada”, completed by Will Dunning Inc. for Co-operative Housing Federation of Canada, based on special tabulations received from CMHC.



Table 6 Core Housing Need in Ontario, in 2001, By Age Group				
<i>Age of Primary Household Maintainer</i>	<i>Total Households</i>	<i>Households in Core Housing Need</i>	<i>% in Core Need</i>	<i>Affordability Gap (Per Month)</i>
15-24	102,385	29,770	29.1%	-\$467
25-34	610,780	94,800	15.5%	-\$526
35-44	972,625	140,915	14.5%	-\$553
45-54	858,400	96,555	11.2%	-\$517
55-64	562,860	65,760	11.7%	-\$432
65-74	479,645	80,450	16.8%	-\$352
75 over	394,850	91,410	23.2%	-\$283
All Ages	398,1540	599,655	15.1%	-\$457

Source: special tabulation from CMHC, using data from the 2001 Census.
 Note: the analysis excludes households whose housing costs exceed their income or have incomes of zero or less. It also excludes households living on reserve whose housing costs are paid through band arrangements, as well as farm households

Financial Analysis of Two Program Alternatives

As was noted in the Introduction, the City of Toronto has proposed some ambitious objectives to expand the availability of assistance to households in need. Six different initiatives are proposed. Two of the initiatives – to assist people to afford rents (through rent supplements and shelter allowances) and to create new rental (through the *Affordable Housing Program*) - can be seen as substitutes or competitors to each other: the first option provides rental assistance within existing housing while the second creates new housing (and subsidizes the construction and financing costs). And, of course, the two approaches can be combined: subsidies through the *Affordable Housing Program* can be used to build new units and then rent supplements can be layered-on to further reduce the rents paid by the occupants.

This section provides a financial analysis that compares the two approaches. The analysis compares:

- The cost of creating a unit with rents at 80% of the market average using the *Affordable Housing Program*, versus
- The cost of reducing rents to 80% of the average market rent using a rent supplement of shelter allowance. Two different scenarios are tested for this option.

Results from the financial analyses are summarized below. Three tables illustrating the analyses are provided at the end of this section.

Cost under the Affordable Housing Program

The *Affordable Housing Program* provides financial assistance from the federal and provincial governments:

- The federal contribution is \$26,600 per dwelling unit, in the form of a forgivable loan that is flowed during the development process.
- The provincial is valued at \$43,400 per unit, in the form of a subsidy of mortgage payments over 20 years.
- The City may also provide contributions, generally in the form of waiving various charges and taxes. In this analysis it is assumed that the City's contribution consists entirely of waiving costs, and that no actual funds flow from the City to the development. Therefore, any City contributions are excluded from the calculations.

In actual dollars, the subsidies amount to \$70,000 per dwelling unit. Since a significant portion of the subsidies flow over time it is useful to calculate a net present value. Using a discount rate of 4% (approximately the current yield on federal and Ontario long-term bonds), the net present value of the subsidies is \$57,271.

This calculation assumes that no further financial assistance is required (for example, to cover operating or administrative costs, or for re-investment in the properties).

Cost for Rent Supplements

This analysis calculates the cost of reducing rents from the average market rent to the same level as results under the *Affordable Housing Program* (80% of average). The calculation assumes a 25-year subsidy period. Results are expressed in actual dollars and as net present values.

The first scenario assumes that rents increase by 2% per year (resulting in corresponding increases in subsidy costs). This assumption of 2% increases is based on an assumption that overall inflation will be 2% per year. Since the rent control regime in Ontario sets rent increase guidelines according to changes in the Consumer Price Index, assuming that rents will rise at the overall inflation rate seems a reasonable assumption for a first scenario. In this scenario, the cost over a 25-year period is \$75,719 in actual dollars (versus \$70,000 for the *Affordable Housing Program*) and \$47,275 as a net present value (versus \$57,271 for the *Affordable Housing Program*).

The second scenario assumes that, through competitive tendering, the rents contracted at the subject rental units are 5% below average market rents. The rents are assumed to increase by 2% per year. In this scenario, the cost over a 25-year period is \$56,789 in actual dollars and \$35,475 as a net present value.

Other scenarios are possible, of course. For example, given recent trends for vacancies and rent increases and the likelihood that those trends will be sustained for several more years, the implications of continued slow rent increases could also be modeled. This would show even lower program costs than were estimated in the second scenario.

Market Impacts of Rent Subsidies

Housing subsidies have been provided on a large scale within Canada since the end of World War II. With more than half a century of experience with assisted housing, much research has been conducted on the impacts, on the individuals assisted as well as on program costs and market impacts. An important issue for program design is that housing allowance programs may stimulate new housing demand which would result in lower vacancies, bringing rising housing costs and therefore rising program costs. A brief summary of the research is provided in “Housing Allowance Options for Canada”, by Meryl Finkel, Carissa Climaco, Jill Khadduri, and Marion Steele⁷.

The report by Finkel, Climaco, Khadduri, and Steele points out that the extent of demand increases and cost increases will depend upon the design of the program, including how many households are assisted, the amounts of assistance provided, and local housing market conditions. A key pair of issues is – how much new demand is stimulated by the program and, secondly, to what extent does the private sector respond to the housing allowance program by providing new housing stock that is appropriate for the program?

Two implications that flow from this are:

- Since the beneficiaries of the City’s expanded housing assistance programs will be chosen from the waiting list, and the waiting lists are extremely long, that program

⁷ Abt Associates Inc., published by CMHC in 2006. Pages 76-78

expansion is unlikely to generate very much new demand – most of the program beneficiaries will already be in housing (albeit housing that they cannot afford).

- Since the private sector will provide very little new low cost rental housing, a large scale housing allowance program should be accompanied by a supply component, whose scale is sufficient to prevent vacancies from dropping to low levels.

The mix of initiatives that is proposed by the City – roughly one unit of new supply for every six units of rent supplements and allowances – appears to be about right, from the point of view of avoiding demand-driven rent increases.

Conclusion

The following table summarizes the costs for the two program options (with two scenarios for the rent supplement option). It shows that:

- At current rents, a rent supplement program would cost 8% more than the *Affordable Housing Program* in actual dollars; expressed as a net present value, however, a rent supplement approach would cost 17% less than the *Affordable Housing Program*.
- For the scenario in which contracted rents are 5% below the average market rent, costs for a rent supplement approach would be 19% less than the *Affordable Housing Program* in actual dollars and 38% lower as a net present value.

Given current and anticipated market trends it should be expected that it should be possible to achieve the second scenario (or even a variation with even lower costs, based on slow rent increases). A rent supplement approach would be considerably less expensive than the *Affordable Housing Program*.

There are some further considerations:

- Given recent trends in development costs for apartments, it is entirely possible that subsidy requirements will be increased for the *Affordable Housing Program*, which may take the form of additional subsidies for projects that have already been committed and/or increases in the amounts of subsidies that will need to be committed in future.
- Given the soft conditions in the Toronto rental market, it must be expected that rent increases will remain subdued for at least a few more years. Meanwhile, project operating costs (including utilities as well as wages for on-site and administrative personnel) will continue to rise. This combination may well result in falling net revenues (the difference between rental revenue minus costs) for *Affordable Housing Program* projects. This would necessitate operating subsidies, which would increase the costs of the *Affordable Housing Program* beyond the currently budgeted amounts.
- The analysis assumes that for the *Affordable Housing Program* subsidies will be limited to the federal contribution for development costs and the provincial subsidy of debt service costs. It is assumed that within the 25-year analysis period there will be no future requirements for re-investment. This may prove to be an overly strong assumption, in which case program costs would be higher than expected as and when there are requirements for re-investment.

Three risk factors have been identified for the costs of the *Affordable Housing Program*. For rent supplements, there is no risk related to development costs; the risks related to future operating costs and requirements for re-investment are borne by the property owners.

The upshot of this discussion is that there is uncertainty about future costs for either program approach. However, there are more upside risk factors for the *Affordable Housing Program* than for a rent supplement approach.

Table 7 2 Program Options for Reducing Rents to 80% Below Average, Costs Calculated Over a 25-Year Period		
<i>Option</i>	<i>Actual Cost</i>	<i>Net Present Value</i>
Affordable Housing Program	\$70,000	\$57,271
Rent Supplements		
Based on Current Market Rents	\$75,719	\$47,275
Contracted Rents 5% Below Market Average	\$56,789	\$35,457
Source: Estimates by Will Dunning Inc.		

Details of Financial Analysis

This section illustrates the calculation of subsidy costs for the *Affordable Housing Program* and the two scenarios for rent supplements. All calculations take as a starting point the average market rent for apartments in the City of Toronto, as of October 2007. Net present values are calculated using a 4% discount rate.

<i>Year</i>	<i>Federal Subsidy</i>	<i>Provincial Subsidy</i>	<i>Total Annual Subsidy</i>	<i>Net Present Value</i>
1	\$26,600	\$2,170	\$28,770	\$28,770
2		\$2,170	\$2,170	\$2,087
3		\$2,170	\$2,170	\$2,006
4		\$2,170	\$2,170	\$1,929
5		\$2,170	\$2,170	\$1,855
6		\$2,170	\$2,170	\$1,784
7		\$2,170	\$2,170	\$1,715
8		\$2,170	\$2,170	\$1,649
9		\$2,170	\$2,170	\$1,586
10		\$2,170	\$2,170	\$1,525
11		\$2,170	\$2,170	\$1,466
12		\$2,170	\$2,170	\$1,410
13		\$2,170	\$2,170	\$1,355
14		\$2,170	\$2,170	\$1,303
15		\$2,170	\$2,170	\$1,253
16		\$2,170	\$2,170	\$1,205
17		\$2,170	\$2,170	\$1,159
18		\$2,170	\$2,170	\$1,114
19		\$2,170	\$2,170	\$1,071
20		\$2,170	\$2,170	\$1,030
21			\$0	\$0
22			\$0	\$0
23			\$0	\$0
24			\$0	\$0
25			\$0	\$0
Total	\$26,600	\$43,400	\$70,000	\$57,271

Source: calculations by Will Dunning Inc.

Table 9
Subsidy Costs for Rent Supplements, Based on Current Market Rents

<i>Year</i>	<i>Average Market Rent</i>	<i>Target Rent (80% of Market Average)</i>	<i>Assistance Required (Subsidy)</i>	<i>Annual</i>	<i>Net Present Value</i>
1	\$985.00	\$788.00	\$197.00	\$2,364	\$2,364
2	\$1,004.70	\$803.76	\$200.94	\$2,411	\$2,319
3	\$1,024.79	\$819.83	\$204.96	\$2,459	\$2,274
4	\$1,045.29	\$836.23	\$209.06	\$2,509	\$2,230
5	\$1,066.20	\$852.96	\$213.24	\$2,559	\$2,187
6	\$1,087.52	\$870.02	\$217.50	\$2,610	\$2,145
7	\$1,109.27	\$887.42	\$221.85	\$2,662	\$2,104
8	\$1,131.46	\$905.17	\$226.29	\$2,716	\$2,064
9	\$1,154.09	\$923.27	\$230.82	\$2,770	\$2,024
10	\$1,177.17	\$941.74	\$235.43	\$2,825	\$1,985
11	\$1,200.71	\$960.57	\$240.14	\$2,882	\$1,947
12	\$1,224.72	\$979.78	\$244.94	\$2,939	\$1,909
13	\$1,249.21	\$999.37	\$249.84	\$2,998	\$1,873
14	\$1,274.19	\$1,019.35	\$254.84	\$3,058	\$1,837
15	\$1,299.67	\$1,039.74	\$259.93	\$3,119	\$1,801
16	\$1,325.66	\$1,060.53	\$265.13	\$3,182	\$1,767
17	\$1,352.17	\$1,081.74	\$270.43	\$3,245	\$1,733
18	\$1,379.21	\$1,103.37	\$275.84	\$3,310	\$1,699
19	\$1,406.79	\$1,125.43	\$281.36	\$3,376	\$1,667
20	\$1,434.93	\$1,147.94	\$286.99	\$3,444	\$1,635
21	\$1,463.63	\$1,170.90	\$292.73	\$3,513	\$1,603
22	\$1,492.90	\$1,194.32	\$298.58	\$3,583	\$1,572
23	\$1,522.76	\$1,218.21	\$304.55	\$3,655	\$1,542
24	\$1,553.22	\$1,242.58	\$310.64	\$3,728	\$1,512
25	\$1,584.28	\$1,267.42	\$316.86	\$3,802	\$1,483
Total				\$75,719	\$47,275

Source: calculations by Will Dunning Inc.

Table 10
Subsidy Costs for the Rent Supplements
Assuming Contracted Rents 5% Below Market Average

Year	5% Below Average Market Rent	Target Rent (80% of Market Average)	Assistance Required (Subsidy)	Annual	Net Present Value
1	\$935.75	\$788.00	\$147.75	\$1,773	\$1,773
2	\$954.47	\$803.76	\$150.71	\$1,808	\$1,739
3	\$973.55	\$819.83	\$153.72	\$1,845	\$1,705
4	\$993.03	\$836.23	\$156.79	\$1,882	\$1,673
5	\$1,012.89	\$852.96	\$159.93	\$1,919	\$1,641
6	\$1,033.14	\$870.02	\$163.13	\$1,958	\$1,609
7	\$1,053.81	\$887.42	\$166.39	\$1,997	\$1,578
8	\$1,074.89	\$905.17	\$169.72	\$2,037	\$1,548
9	\$1,096.39	\$923.27	\$173.11	\$2,077	\$1,518
10	\$1,118.31	\$941.74	\$176.58	\$2,119	\$1,489
11	\$1,140.67	\$960.57	\$180.11	\$2,161	\$1,460
12	\$1,163.48	\$979.78	\$183.71	\$2,204	\$1,432
13	\$1,186.75	\$999.37	\$187.38	\$2,249	\$1,404
14	\$1,210.48	\$1,019.35	\$191.13	\$2,294	\$1,377
15	\$1,234.69	\$1,039.74	\$194.95	\$2,339	\$1,351
16	\$1,259.38	\$1,060.53	\$198.85	\$2,386	\$1,325
17	\$1,284.56	\$1,081.74	\$202.83	\$2,434	\$1,299
18	\$1,310.25	\$1,103.37	\$206.88	\$2,483	\$1,274
19	\$1,336.45	\$1,125.43	\$211.02	\$2,532	\$1,250
20	\$1,363.18	\$1,147.94	\$215.24	\$2,583	\$1,226
21	\$1,390.45	\$1,170.90	\$219.54	\$2,635	\$1,202
22	\$1,418.26	\$1,194.32	\$223.94	\$2,687	\$1,179
23	\$1,446.62	\$1,218.21	\$228.41	\$2,741	\$1,157
24	\$1,475.56	\$1,242.58	\$232.98	\$2,796	\$1,134
25	\$1,505.07	\$1,267.42	\$237.64	\$2,852	\$1,113
Total				\$56,789	\$35,457

Source: calculations by Will Dunning Inc.