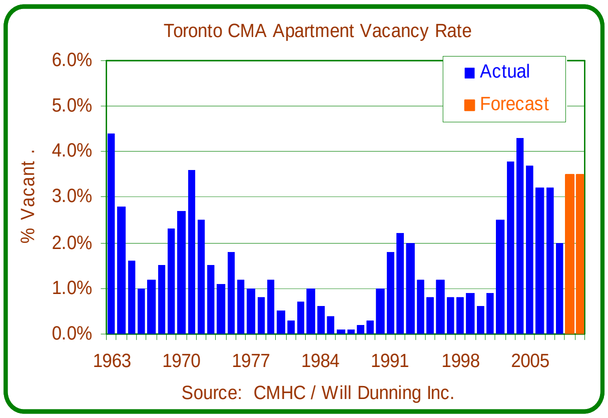
Rental Apartment Market

Toronto CMA, Fall 2008

Overview

The apartment vacancy rate in Toronto CMA fell sharply during 2008, with the October rate at 2.0% versus 3.2% a year earlier and 2.8% in April 2008. The number of vacant units dropped by almost 3,500 units, and 6,225 units were vacant as of October 2008.



CMHC also reports on availability of rental housing – this includes units that are vacant as well as units for which notice has been given and the unit has not yet been leased. The availability rate fell, to 3.7% in October 2008 from 5.0% in October 2007. With more than 11,000 rental apartments available, there is still a great amount of choice within the Toronto CMA rental market.

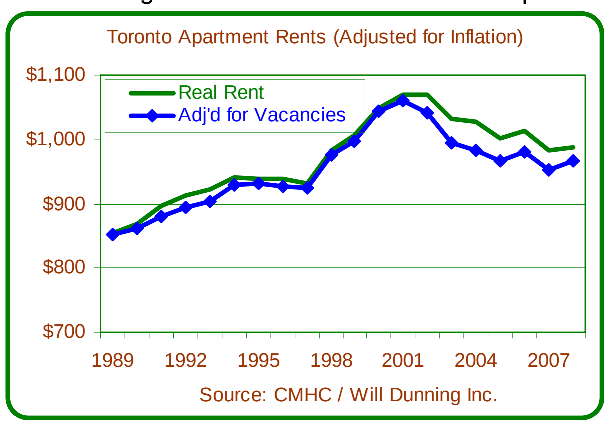
The lower vacancy rate allowed rents to increase at a faster rate than in prior years. The average rent reported by CMHC increased by 3.0% from a year earlier. CMHC states that the increase was partly due to additions of new inventories with higher rents. Looking just at units that were in both the 2007 and 2008 surveys, CMHC found an increase of 1.7%.

Due to rapid increases in energy costs, the overall inflation rate for Toronto CMA was 2.7% in the 12 months to October 2008. Therefore, in inflation-adjusted (or "real") terms, the average rent increased by 0.3%. (However, if we use CMHC's estimate that rents increased by 1.7% for units covered in both 2007 and 2008, rents fell by 1.0% in inflation-adjusted terms.)

There is a concept of "natural vacancy rate" - the vacancy rate at which rent increases match overall inflation. For Toronto CMA, I have estimated that the natural vacancy rate is 2% or less. For six consecutive years (2002 to 2007) the vacancy rate exceeded 2%, and during that period rent increases were less than the inflation rate. In 2008, with the vacancy rate at 2.0%, rents increased more or less at the same rate as overall inflation. During the past seven years, the average rent in Toronto CMA has fallen by 7.6% in "real" terms.

The chart below shows the average rent in inflation-adjusted ("real") terms. It shows that the average "real" rent has returned to the same level as in 1998, although it remains higher than the rents seen prior to 1998.

Another perspective (the blue line, which may reflect the view of landlords) shows that rents in real terms, after adjustment for vacancies, peaked in 2001/2002. As of 2007, the "net real" rent fell by 10% from the peak. With lower vacancies in 2008, there was some recovery of estimated net real rents. The figure for 2008 is 8.6% below the peak.



Interpretation

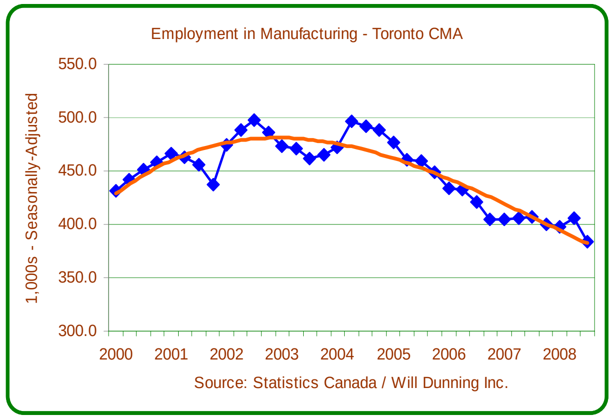
A year earlier, the vacancy rate was flat – the 3.2% vacancy rate in October 2007 was unchanged from the rate seen in 2006. With the large drop in the vacancy rate for 2008, my interpretation looks for changes that might have affected rental demand.

Several factors can potentially explain the sharp drop in the vacancy rate for 2008, including job creation and changes in home ownership activity.

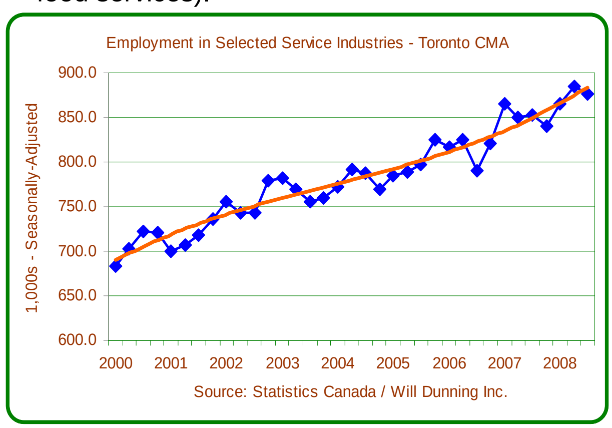
- The Toronto economy continued to generate new jobs during 2008. While there is always uncertainty about the accuracy of the employment data (as is well known by any regular readers of *Housing Market Digest*), it does appear that employment has been growing at about the same rate as the population. In fact, according to the published data, employment growth has been stronger in 2008 (2.7% in the year to September 2008) than in 2007 (1.9%). If this data is correct, the more rapid job creation in 2008 would result in increased household formation. Most of the new households would make their first step into rental housing - increased household formation in 2008 might explain some of the drop in the vacancy rate.
- In terms of the impact of home buying activity on the rental market, what matters most is how many new dwellings are completed and become occupied. CMHC's data shows that in the year up to September 2008, there were increased completions of home owner units – the number of low-rise completions was flat but there were more completions of condominium apartments. This suggests that in 2008 there would have been more movements out of the rental market, which would tend to put upward pressure on the vacancy rate. Moreover, an increase in the number of completions of rental units should also have put upward pressure on the vacancy rate.

Housing Completions in the Toronto CMA, for 12-Month Periods Ending in September				
Year	*Low-Rise Ownership*	*Condo Apartment*	*Rentals*	*Total*
2007	21,448	7,936	574	29,958
2008	21,503	11,693	1,657	34,853
Source: CMHC, compiled by Will Dunning Inc.				

- Yet, the vacancy rate fell sharply. This indicates that the number of moves into rentals (due to job creation) exceeded the number of out-moves.
- I suspect that even more important than the amount of job creation is its composition – the types of jobs being created and their locations. The manufacturing sector in the Toronto area has been hammered by the strong Canadian dollar, high energy costs, and the downturn in the US economy. Statistics Canada data (shown in the next chart) suggests that employment in manufacturing within the Toronto CMA has fallen by 100,000 since the peak in 2002 to 2004. The manufacturing sector is more present in "905" than in "416", and therefore the manufacturing recession has had more impact on the housing market in "905". Since the "905" housing market is primarily home ownership, the impact on the rental market has been relatively muted.



- However, key services industries have continued to expand (at least up to the time of the 2008 rental market survey). This includes the financial sector and related professional services. Many of the new jobs have been located within the downtown core. This in turn has created new jobs in other supporting service industries within the core (such as food services, retail trade, and personal services). These new jobs are most likely to create needs for rental housing. The result is that downtown Toronto (CMHC's zone 1) had a vacancy rate of just 1.1% this year. (The next chart illustrates the strong growth in Toronto CMA employment for four sectors: finance, professional services, business services, and accommodation and food services).



Two other factors that may have caused rental demand to increase in the past year are:

- As has been discussed, rents have fallen in real terms during the past seven years. Meanwhile, a relatively strong economy has allowed wages to rise in real terms (more rapidly than overall inflation). This combination has no doubt caused rental demand to increase.

- Secondly, delays in construction of new condominiums have forced some tenants to stay in their rental dwellings longer than they had anticipated. These construction delays have resulted in a sharp expansion in the under construction inventory for condo apartments. At the end of September there were 33,919 condominium apartments under construction in the Toronto CMA. As I discuss below, this very large pending inventory is setting the stage for a substantial correction within the condo market which will, eventually, affect the rental market as well.

The Outlook

I didn't do very well with my forecast for 2008 – a year ago I forecast that the vacancy rate would rise this year, to 4.0%. Instead, it fell to 2.0%.

The factors that caused this "surprise" in 2008 are:

- Job creation expanded, whereas I had expected a slowdown.
- Job creation was centered in this occupations and locations where it was most likely to generate demand for rentals.
- Delays in condominium completions resulted in reduced out-moves from the rental market.

For 2009, I expect that these factors will move in the opposite direction, and once again, I am forecasting that the vacancy rate will rise.

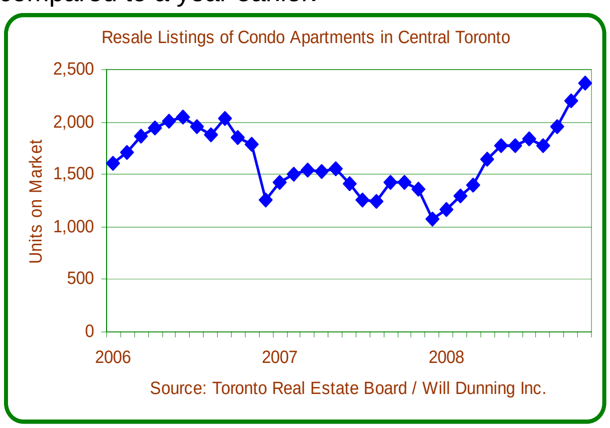
However, the path and the timing are uncertain. It is quite likely that vacancies will continue to tighten for a while.

I see the following effects:

- The meltdown of the stock market during the past three months will result in a very sharp and very rapid downturn in the Toronto CMA economy. It is obvious to all of us that this process is underway, and it is already showing up in the employment data from Statistics Canada. I expect that there will be a very sharp drop in Toronto CMA employment during the next 12-18 months – in the range of 125,000 jobs, or 4-5%.
- Many of the job losses will occur within the core.
- Falling employment means fewer new households being formed by young people and less movement into rentals.
- Some renters will move out to live with families or double up with others.
- But, there will also be fewer moves out of rentals into home ownership and there will be some moves of home owners back to renting.
- Meanwhile, the housing that is now under construction will eventually become available for occupancy, and with the weaker economy, that supply will exceed the need.
- Most of the new completions will be in the ownership sector. This includes the 36,000 condo apartments that were under construction at the end of October.

Initially, vacancies could actually fall in the rental sector. But, there will be a very large number of vacant condo apartments. As the owners resolve those vacancies in the condo sector (by reducing prices and rents), there would be some shifting of vacancies to rentals.

It appears that this process – excess supply in the condo sector and owners acting to sell the units - may be underway already. The next chart shows data from the Toronto Real Estate Board on the number of condominium apartments listed for sale within its central districts (districts C01 to C15). For 2006 and 2007, and the first nine months of 2008, the data shows a normal seasonal pattern of increasing inventories during the spring followed by a drop-off late in the year. However, for 2008, the late year drop-off hasn't occurred, and as of November the number of condominium apartment listings has increased by 1,000 units (75%) compared to a year earlier.



Thus, it appears that we are now on the cusp of an increase in the number of vacant apartments. Initially, those vacancies are in the ownership sector. I expect that during the next 12 to 18 months there will be a very substantial further rise in the number of vacant ownership apartments. ***As the owners resolve this vacancies (by selling them, or by renting them for reduced rents), the vacancies will - eventually - become distributed across both the ownership and the rental sectors.***

To summarize, I see two key processes that will combine to produce higher vacancies in the rental market:

- Reduced demand for all forms of housing (ownership and rental) due to job losses and
- Increased housing supply, due to decisions that were made during better economic times.

We saw the same process in two prior economic recessions, in the early 1980s and early 1990s. In both of those instances, there were sharp rises in the apartment vacancy rate.

My forecast is that the vacancy rate might increase slightly in April, but then rise more substantially, to about 3.5% in October. For 2010, I expect the vacancy rate may not be very different.

In recent years, including the 2008 survey, CMHC has found that vacancy rates are highest at the low end of the market and lowest for high rent units. As vacancies increase during 2009, I expect that the rise will be most rapid in the upper part of the rent spectrum.

Rents won't increase by very much. As 2009 develops, and into 2010, we will see the return of significant rental incentives, such as free rent periods, free parking, or gifts for new tenants.

CMHC Report

CMHC has produced a detailed and very good report on the rental market (although of course we agree on some points and disagree on others). The CMHC report for Toronto and other major markets across Canada can be found at:
https://www03.cmhc-schl.gc.ca/b2c/b2c/init.do?language=en&z_category=0/0000000079

About Will Dunning Inc.

Will Dunning specializes in analysis of the GTA housing market. His main services are to produce market feasibility studies of proposed housing developments and to provide expert witness testimony on housing market issues.

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How to Reach Will Dunning

For more analysis of housing markets, contact Will Dunning at:

Telephone: 416-236-5115
Email: wdunning@sympatico.ca
Web site: www.wdunning.com