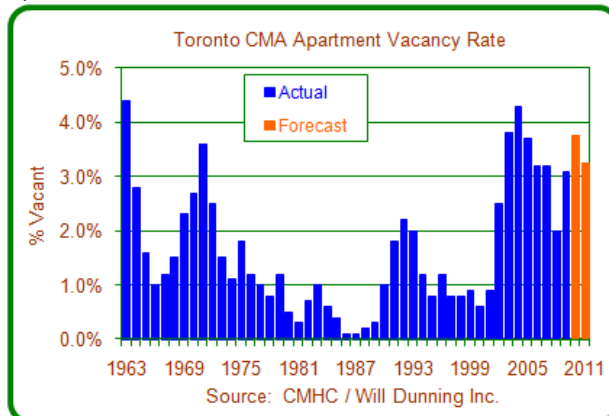


Rental Apartment Market

Toronto CMA, Fall 2009

Overview

The apartment vacancy rate in Toronto CMA rebounded during 2009, with the October rate at 3.1%. This was up sharply from the 2.0% rate found a year ago, but was similar to the 3.2% rate seen in both 2006 and 2007. The number of vacant units rose by about 3,200 units, and about 9,400 units were vacant as of October 2009.



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 rose to 5.0% in October 2009 from 3.7% a year ago. With more than 15,000 rental apartments available, there is a great amount of choice within the Toronto CMA rental market.

The data on rents and rent increases has some ambiguity. The average rent was essentially flat: \$1,011 this year, down slightly from the average of \$1,014 in 2008. CMHC also provides a calculation for a “constant sample” of structures that were in both the 2008 and 2009 surveys – on this basis, CMHC found an increase of 2.0%.

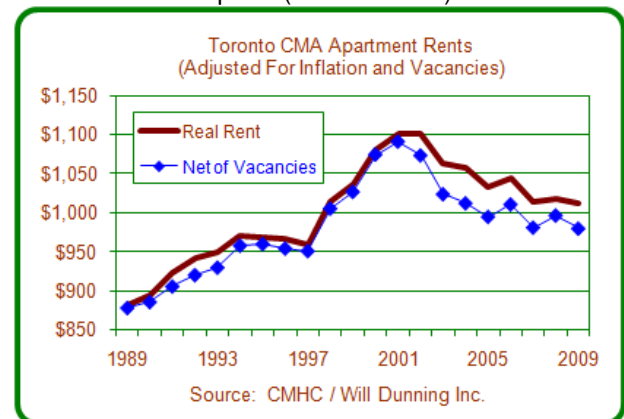
The overall inflation rate for Toronto CMA has been quite low (just 0.3% in the year to this October), due largely to reduced energy costs. Therefore, in inflation-adjusted (or “real”) terms, the average rent fell by 0.6%. (However, if we use CMHC’s estimate that rents increased by 2.0% for the constant sample, rents rose by 1.7% 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 estimate that the

natural vacancy rate is 2% or less. The vacancy rate has been equal to or greater than 2% for past 8 years (2002-09). During that period, the average rent increased by only 3.7%, which is less than the overall inflation rate (12.9%). Consequently, during 2002 to 2009, the average rent in Toronto CMA has fallen by 8.1% 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 2009, the “net real” rent is 10.2% below the peak (seen in 2001).



Interpretation

The rise in the vacancy rate this year is not surprising. The economic recession has reduced housing demand, as job losses have undoubtedly reduced formation of new households and caused some people to double-up or move back with parents. Meanwhile, new housing that started construction prior to the recession was completed in relatively large numbers, and the growth in the housing inventory has exceeded the housing requirements that exist at this time.

Statistics Canada’s estimates of employment indicate that in the Toronto CMA there were about 35,000 jobs lost during the year to October 2009.

There is always uncertainty around these estimates (as is well-known by any of you who read Housing Market Digest). Moreover, it is quite possible that Statistics Canada will revise the employment numbers downwards, and the estimate of jobs lost could be increased. Regardless of the uncertainty, the recession has been less severe than was expected a year ago.



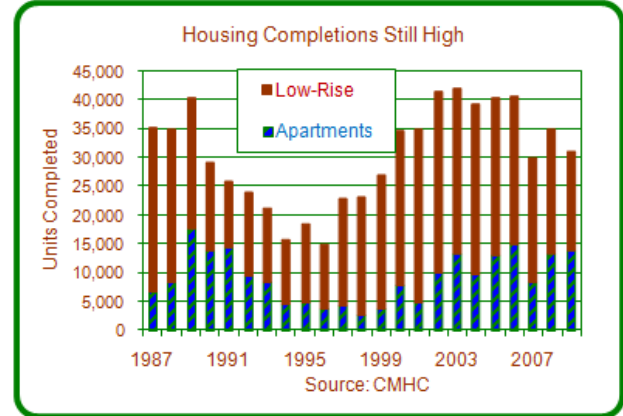
Even more important than the amount of job loss is its composition – the types of jobs affected and their locations. Job losses have been concentrated in the manufacturing and construction sectors (especially construction of low-rise dwellings). Those jobs are more present in “905” than in “416”, and therefore the manufacturing recession has had more impact on the housing market in “905”. Since the “905” housing market is primarily home ownership, the negative impacts have been larger for the new home ownership market than for rentals. Conversely, employment has continued to expand in the financial sector, which is largely located in the core of the City. But, there have also been some job losses in the trade sector as well as in hospitality industries, which has negatively affected demand for moderate cost rentals throughout the Toronto CMA.

Recessions always have their greatest impacts on young age groups, as new hiring drops sharply, and this has no doubt been a major contributor to the rise in the vacancy rate.

New home sales dropped sharply during 2008 until mid-2009, but homes that were sold earlier resulted in high volumes of housing starts and sustained a relatively high volume of completions. As is illustrated in the next chart and the table, the number of completions was lower in the past year (the 12 months up to September) than in the prior year, but not by much. Completions of this housing resulted in moves out of rentals, and clearly the

number of move-outs exceeded the number of moves into rentals, since vacancies increased.

There have been continued delays of completions of new condominiums. This has delayed moves out of the rental sector. If not for the delays, the rise in the vacancy rate would have been greater.



Year	Low-Rise Ownership	Condo Apartment	Rentals	Total
2006	25,309	14,143	994	40,446
2007	21,448	7,936	574	29,958
2008	21,503	11,693	1,657	34,853
2009	17,017	12,670	1,229	30,916

Source: CMHC, compiled by Will Dunning Inc.

I am often asked if my forecasts for the Toronto housing market (including the rental market) consider immigration. Many people want to argue that a high level of immigration will prevent vacancies from rising. My response is that high immigration has been a factor for many years, and has produced the market outcomes we’ve seen. What matters is changes in the amount of immigration. With the Toronto area having been one of the areas most affected by the recession, and with moderate income industries in dire condition, Toronto has become less attractive for immigrants. Immigration has probably slowed – and for the next few years will probably remain lower than prior to the recession. (We don’t know for sure what’s happened to immigration – city level data only becomes available every five years through the Census – between Censuses there are estimates of migration to cities but these estimates are revised after each Census.)

A final factor to consider is that demand for rentals is sensitive to the level of rents. As has been noted, rents have fallen in real terms since 2002,

and this has no doubt helped to support demand – if not for these soft rents, the vacancy rate would be even higher than it is.

Resale market activity is sometimes mentioned as a factor that affects vacancy rates. I'm not convinced. To me, what drives vacancies is changes in the demand and supply of housing. Resale activity doesn't affect demand or supply for housing – it just sorts who lives where, and therefore changes in resale activity should have little or no impact on vacancies. There can be minor effects through two processes. If buyers create (or remove) basement apartments, that affects supply. Secondly, as resale market conditions evolve, there can be changes in vacancies within the ownership stock – those changes will theoretically cause opposite changes in the rental sector (exactly the same argument can – and should – be made about the non-impact of condominium conversion).

In recent years, CMHC's survey has found that vacancy rates are highest at the low end of the market and lowest for high rent units (with vacancy rates below average for units with rents of \$1,000 or higher). In 2009, however, as vacancies expanded, the expansion was greatest for upper end units, with the consequence that vacancy rates are flatter across the rent spectrum. This was the predictable consequence of a recessionary environment.

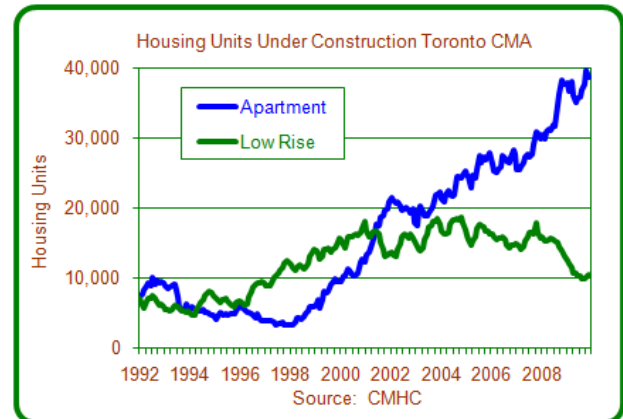
The Outlook

I was pleasantly surprised by the 2009 survey results, in the sense that the outcome was more-or-less what I expected (a year ago I forecast that the vacancy rate would increase to 3.5%. I got the direction right but the rise was less than my forecast – the recession was less severe than I expected).

The economy is subject to a mixed set of influences. The on-going economic disaster in the US will continue to hurt our export-oriented industries. On the other hand, the resurgence of housing values and the stock market since last spring will encourage job creation (through "wealth effects"). I expect that the outcome will be a recovery, with potentially a rapid rebound of job creation during 2010, but slower growth in 2011.

For the 2010 rental market, I see countervailing forces: the economy will most likely be in recovery mode: rising employment will generate more

demand for rentals; however, there will be very substantial completions of new housing – condominium apartments in particular – which will cause increased movements out of rentals. I expect that the outcome will be a further rise in the vacancy rate to 3.5% to 3.75%. During 2011, there should be a slowdown in housing completions and by October 2011, the vacancy rate may fall to 3.0% to 3.25%



The timing of the rise in vacancies is uncertain. Initially, there will be increasing vacancies in the condo apartment sector, since the number of investor-owned units that will be delivered will be vastly in excess of the market need. As the owners resolve those vacancies in the condo sector (by reducing rents or by selling them – at falling prices), there would be some shifting of vacancies to rentals.

There is always uncertainty about what proportion of the new condominiums will be made available as rentals. I say that it doesn't matter very much. Most new condo apartments will be occupied by people who would otherwise be in conventional rentals – whether the condos are occupied by tenants or owners won't make much difference – what matters is that when they are occupied, demand for conventional rentals will be reduced.

To summarize, I see two key processes that have combined to produce higher vacancies in the rental market, and will likely cause a further rise in 2010:

- 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.

Based on the forecasts for vacancy rates, rents are likely to be unchanged in 2010 and then increase by 1.0% in 2011. By October 2011, the average rent would be 10% lower in real (inflation-adjusted terms) than at the peak in 2002. They would be about 3% higher (again, in real terms) than during the mid-1990s (prior to the introduction of the Tenant Protection Act).

My forecasting model suggests that construction of new purpose-built rentals is determined largely by the levels of rents and interest rates, and that vacancy rates have little or no impact on these investment decisions. This makes sense given that vacancy rates will have little impact on the financial modeling. Based on the forecasts for rents and expectations for interest rates, starts of new rentals will be in the range of 1,400 units in both 2010 and 2011. In reality, of course, there will be substantially more rental supply in the form of investor-owned condominiums.

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 noted earlier, this changed in 2009, as vacancies increased rapidly in the upper part of the rent spectrum, and the distribution became more uniform. For 2010, I expect that vacancies will become more concentrated at higher rent levels.

Rising vacancies should bring the return of significant rental incentives, such as free rent periods, free parking, or gifts for new tenants.

Risks

This forecast for the Toronto rental market is highly influenced by “wealth effects” arising from the very robust recovery of stock markets and housing values (now at all-time record levels in the GTA and many other areas of Canada).

There is some risk that the stock market has gotten ahead of realistic economic prospects (the Bank of Canada has said as much). In the event of a significant and prolonged stock market correction, there would be subsequent negative consequences for housing values. The employment situation would be weaker than my forecast expects. Therefore, rental demand would be weaker; meanwhile, there would be continued moves out of rentals into newly completed housing

– the vacancy rate would be higher than expected in 2010, and the vacancy rate could potentially increase further in 2011.

On the other hand, the stock market and housing values could continue to inflate, which would mean an even stronger expansion of employment, and vacancy rates would be lower than forecast.

Probabilities? I’d say 60% for the main scenario, 30% for the “correction” scenario, and 10% for the “boom” scenario (I use that term deliberately – “boom” should be a dirty word in the context of the GTA housing market).

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-chl.gc.ca/catalog/productList.cfm?csid=1&cat=79&lang=en&fr=1261161700421>

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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