Housing Market Digest

Greater Toronto Area, April 2021

When investments in rentals have costs exceeding the rents, that's seen as a problem, but when home buyers have costs greater than they would pay in rent, it's ok. The situations have the same cause: repayment of mortgage principal is building equity.

Negative Cash Flows for Investments

Commentary (in business media and on the Internet) is once again concerned about investment condos, and the fact that many recent purchases are in negative cash flow (the rent received is less than the costs that result from mortgage payments, taxes, and condo fees).

Last month I commented on Will's Theory of the Housing Market: it doesn't matter whether housing is occupied by renters or owners, or if it's owned by landlords or owner-occupants. What matters is how much housing exists versus how much housing is required.

A corollary is that purchases made by owners and investors have roughly the same financial implications. If a purchase makes sense on an owner-occupancy basis, it probably also makes sense as an investment.

Home Buyers Often Compare the Costs of Owning versus Renting

Consumer surveys by Mortgage Professionals Canada have found that home buyers do a lot of work and consider a lot of factors. Among people who expect to buy their first home during the next five years, the factor given the most consideration is the total cost of ownership. In the 2019 year end report, the average score for this factor is very high, at 8.47 on a 10-point scale. This is shown in Table 4-6 on page 58 of this report:
https://mortgageproscan.ca/docs/default-source/consumer-reports/housing-market-report---year-end-2019-(english).pdf
Other factors will be given considerable amounts of consideration, including the amount of interest paid each year (8.03 out of 10) and the cost of owning compared to renting (7.57). All of these are high scores, highlighting that deciding to buy a home is a challenging and complicated event that requires a lot of work.

People buying homes are making a choice (consciously or unconsciously) between owning and renting. My experience is that to varying degrees, they have some consciousness of this and to varying degrees they compare the monthly cost of owning versus renting an equivalent home.

From that perspective, most people buying a home and taking a sizable mortgage are in a negative position in terms of the difference between renting versus owning – just like investors are.

I did a small survey of asking rents and list prices for condominiums in three locations, doing my best to compare similar unit types. The locations are downtown Toronto, Etobicoke waterfront, and Mississauga Square One. Results differ, but they are broadly similar for the three locations. The table below uses the Toronto results, to illustrate the calculations that might be made by both owner-occupants and investors – comparing the monthly costs of ownership versus monthly rent.

As is shown, this purchase is in a negative position versus renting (the -$921 shown in the eight row of data).

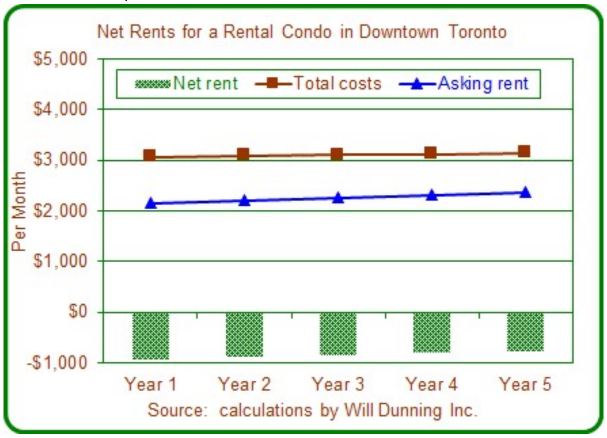
But, as I've argued elsewhere, the part of the payment that is repayment of principal should be viewed as a form of saving. So, the last three rows in the table recalculate the costs and the net rent excluding principal repayment. For both owner-occupants and investors, the negative cash flow that results from principal repayment turns positive once repayment is recognized as saving.

Comparing the Monthly Costs of Owning versus Renting a Condominium Apartment in Downtown Toronto	
List price	$706,000
Mortgage amount (80% of price)	$564,800
Monthly mortgage payment (@2.1%, 25-year amortization)	$2,419
Common charges	$417
Taxes	$236
Total costs	$3,071
Asking rent	$2,150
Net rent	**-$921**
Interest-only basis	
Interest cost	$984
Total monthly cost	$1,637
Adjusted monthly net rent	**$513**
Source: calculations by Will Dunning Inc.	

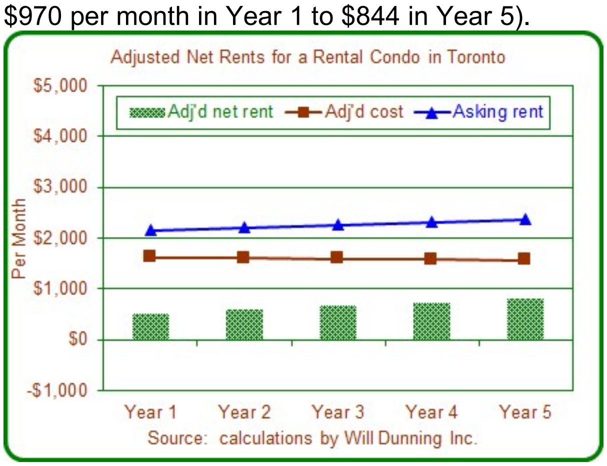
The Effect of Time

The data in the table is for the first month. Over time, the results change. The mortgage payment is fixed for five years, but there will be changes for rents, taxes, condo charges, and other expenses. The two charts below show estimated costs and rents for the first five years, on the assumption that the variable cost items rise by 2.5% per year.

In the initial analysis, the negative cash flow is reduced from an average of $921 per month in Year 1 to $766 in Year 5.



In the analysis that excludes the saving via principal repayment, the adjusted net rent rises from an average of $527 per month in Year 1 to $809 per month in Year 5. This improvement is bolstered by the reductions of remaining principal, which cause monthly interest costs to fall (from $970 per month in Year 1 to $844 in Year 5).



Whether these returns will satisfy investors (and owner-occupants) as a reasonable return on their invested equity is an open question. But, this analysis indicates that buying (by owner-occupants or investors) provides a positive financial return, and the return improves the longer the ownership period.

Condo purchase (and other options) can make sense without making outrageous assumptions about growth of values. But, the buyers are aware that changes in value will be an important factor in the outcome that they actually achieve.

In this example, over 5 years, taking into account (1) the equity invested (including an allowance for land transfer tax and other acquisition costs), (2) the negative cash flows, and, (3) the disposition, considering that the principal has been reduced but also deducting the selling costs: the (annual) Internal Rate of Return on investment is:

- 6.4% if the value grows by 2.5% per year.
- The IRR is -2.3% if there is no change in the property value.
- The IRR is 13.9% if the value grows by 5% per year.

I'm not presenting these financial estimates as definitive: they are one situation, out of many possibilities. But, I'm confident the overall conclusion is reasonable.

Revisiting the Demographic Requirements

One further note on last month's HMD: in 2006, there were just under 1 million low density homes in the Toronto CMA. The supply shortfall since then (130,000 dwelling units) is a big deal.

I'm thinking about doing the same analysis for major markets across the country.

I repeat one of the conclusions from last month: new policies that reduce purchases by investors would make the market easier for owner-occupant buyers, but it would also reduce available rental supply, making conditions more challenging for renters. If such a policy works as intended, it will have the long-run effect of further constraining the growth of the housing supply: pre-construction purchases by investors help builders get financing for new projects.

I'm looking forward to seeing you again.

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