Housing Market Digest

Greater Toronto Area, August 2022

Repeating Myself, About Purpose-Built Rentals

I have written about this several times…

In 1990, I began to persuade myself that for the foreseeable future, most new rental supply will come from individual investors (often in the form of rented condominiums) rather than in purpose-built rental projects (buildings that are constructed for the purpose of offering rentals).

The argument is that publicly-traded companies and institutions are mainly concerned about the initial cash flows, whereas individuals can pay more attention to longer time frames (incremental growth of net income and growth of equity that results from rising property values and repayment of mortgage principal). The consequence is that individuals can make a positive decision at rents that are lower than will be required by the so-called traditional investors.

There are some interesting corollaries to this.

Firstly, there are some places in Canada where local companies have continued to create significant amounts of new purpose-built rentals. But, these are usually privately-held (often family-owned), not publicly-traded or institutions. Those local companies can make decisions similarly to individual investors, giving a lot of attention to long-term growth.

Secondly, if there is a lot of purpose-built investment in new rentals, it probably means that rents have overshot where they should be. That overshooting would be a short-term situation, because it will result in over-building in the new rental market, which will eventually result in excessive supply of new product, and then a downward rental adjustment.

This is like a modern version of the "Hog Cycle" (or "cobweb model") that I learned about in my first year of university. Here is a quick explainer: https://en.wikipedia.org/wiki/Pork_cycle

In the housing market, it can be expected that a "short-term" over-supply phase will actually take a few years to develop and then more years to resolve, because of the long production times that are involved.

It has seemed to me that this (overshooting of rents, with supply consequences) has developed in the rental sector. Rents for new buildings have been rising rapidly since about 2016/17 (meanwhile, interest rates were quite low, providing additional incentive).

I'm writing this now, because I have recently seen two comments that, in combination, have persuaded me that overshooting has for sure happened (and that the downward adjustment is beginning).

The first is that a large owner of rental buildings is doing a "capital rotation" - selling a small number of its older buildings to finance acquisition of newly-constructed buildings. (Given what I'm saying here, I wonder if ultimately, the older buildings will perform better than the new ones.)

Secondly, (and this was from a different source, so it isn't related to the company that I just mentioned) I saw a comment about the rents that were expected when decisions were made to invest in new buildings. Those rents were extremely high at that time. There might be some periods when rents are close to those expectations, but over the long term, I expect that attained rents will be considerably lower than was expected.

In other words, consistent with the hog cycle model: expectations about rents have overshot by very significant amounts, resulting in excessive amounts of new investment.

Something else is happening: I noticed a comment that in Toronto as many as 50 buildings that were expected to start construction soon are now being shelved (this includes condos and purpose-built rentals). In part this can certainly be attributed to the very sharp rise in interest rates, as well as very rapid growth of development costs (including construction costs and higher government-imposed costs).

But, I also suspect that there has been some realization that the rents that had been expected aren't going to be consistently achievable.

There is a very large inventory of new rentals now under construction in Canada: about 125,000 units in purpose-built rentals, as well as a large number of new rentals that will be created in condominium projects (there are almost 150,000 condo units under construction at present). In the Toronto CMA, under construction inventories currently include about 12,000 purpose-built rentals and more than 65,000 condominiums.

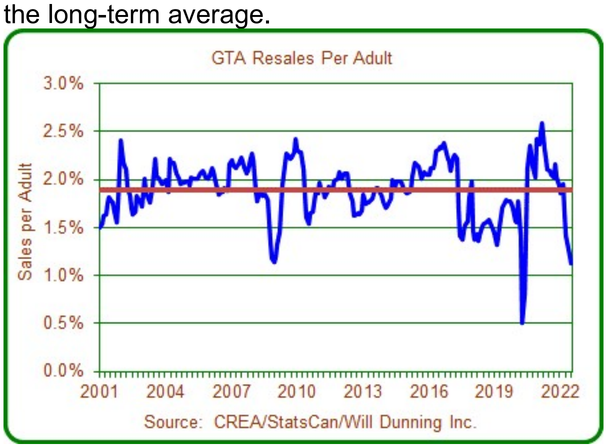
As those buildings become available for occupancy and the owners of the new rentals (purpose-built and investor-owned condos) compete to find tenants, I expect that there is going to be disappointment.

Last thought: this idea that there is a surplus of new apartments might seem inconsistent with the argument that there is a very large overall shortage of housing in Canada (and especially in the GTA). But, even with shortages there are limits to how many people can and will pay high rents.

Resale Market

In the Canada edition for August, I make an argument that interest rates are unnecessarily high, creating elevated risk for the Canadian economy. I see evidence that a housing-led recession is developing.

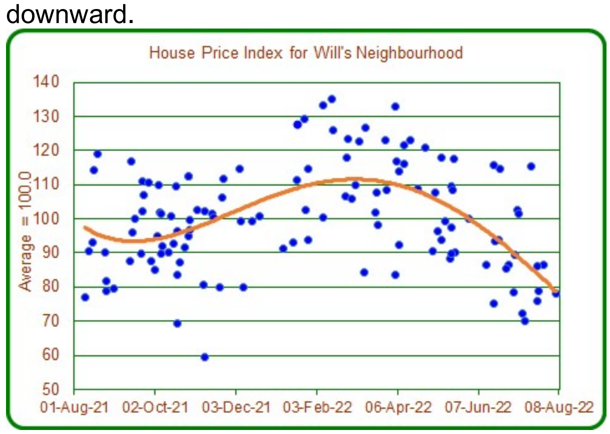
In the GTA, the sales rate slowed further in July, to an annualized rate of 63,500. On a population-adjusted basis, this was 41% below the long-term average (2001 to the present). For all of Canada, the shortfall in July was less severe, at 18% below the long-term average.



Sales still are partly reflecting lower interest rates that were committed previously, so I expect that we haven't yet reached the bottom that will result from current rates (a 5-year rate close to 5% and variable rates above 4%, versus a neutral rate that I estimate at 2.6%). September and October will provide a better test.

The sales-to-new-listings ratio (41% for July) is increasingly below the balanced market threshold (52% for the GTA). As you know, prices are falling, although that is difficult to measure.

For my own amusement, I am building a dataset of transactions in my community, that looks at the relationship between selling prices and taxes (low-rises only). As of early August, that index is considerably lower than a year ago, and falling rapidly. There is a lot of noise in this data: at every point in time, variations in the index values are much larger than I would have expected. This tells me two things: a lot of property value assessments are not very accurate and/or a lot of people haven't done very well at determining values of the properties that they are buying or selling. There is uncertainty about the "true" trend, but it is clearly downward.



How to Reach Will Dunning Inc.

Email: wdunning@sympatico.ca
Web site: www.wdunning.com
Twitter: @LooseCannonEcon

Disclaimer of Liability

This report has been compiled using data and sources that are believed to be reliable. Will Dunning Inc. accepts no responsibility for any data or conclusions contained herein.