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Executive Summary

The report *Responding to the Challenge: The Economics of Investment in New Rental Housing in 1999*, prepared by the author on behalf of the Ontario Ministry of Municipal Affairs and Housing (MMAH) in February 1999, provided an examination of the potential returns from investment in new rental housing in Toronto. The report was an update of the analysis in a previous report, *The Challenge of Encouraging Investment in New Rental Housing in Ontario*, prepared by the author for the MMAH in 1995.

The main finding of the *Responding to the Challenge* report were that the attractiveness of investment in new rental housing had improved considerable since 1995. The key factors behind the improvement were the *Tenant Protection Act*, which provided balance in the treatment of landlords and tenants, more equitable property taxes for condominium-registered rental buildings, and lower interest rates.

Since the preparation of *Responding to the Challenge*, there have been a number of changes which affect the environment for rental investment. The key changes include:

- Tightening rental markets
- Higher rents
- Higher interest rates
- Higher development costs
- Improved CMHC underwriting criteria for new rental housing

This report analyses the effects of these changes on the economics of new rental projects and concludes that the economics of rental investment have worsened since the completion of the *Responding to the Challenge* report in February. It further concludes that unless there is a substantial change in terms of either increased revenues (i.e. higher rents) or reduction in costs and/or interest rates, it is unlikely that there will be much new rental construction in Toronto.

The two key recommended initiatives from the *Responding to the Challenge* report in February which have not been addressed are:

Update on the Economics of Investment in Rental Housing in Toronto

Prepared for:

Rental Housing Supply Alliance

Prepared by:

GREG LAMPERT - Economic Consultant

December 1999

- **GST treatment of rental housing the same as commercial projects** - the most obvious initiative available to the federal government is to treat rental housing the same as other types of commercial development. Owners of rental housing are subject to punitive GST treatment on the development of new projects and are denied input tax credits on operating costs. Unlike rental housing landlords, the owners of other types of commercial projects effectively do not pay GST - they receive full input credits for all GST paid. It is difficult to see how the federal government can justify taxing residential rental construction - especially with the looming shortages of rental accommodation in major cities across Canada.
- **Reduce development charges and other charges** - Toronto has imposed a development charge on new rental apartment projects which will reach \$1,692 and \$2,644 for 1-bedroom and 2-bedroom units, respectively, in 2001. There is a phase-in period prior to the introduction of the full development charge. In suburban municipalities, development charges are much higher - in Mississauga, for example, the development charges for apartment units of 750 square feet or more total \$11,162. In addition, there are a variety of other municipal fees and charges which apply to new development. These all add to costs and serve to discourage new rental construction. Reductions in these charges would clearly improve the economics of rental investment.

The report assesses the impacts of such actions on the economics of new rental projects. It concludes that treating rental housing the same as commercial construction for the purposes of the GST, and reduction in other taxes and charges, would have a very beneficial effect on the economics of rental investment. Action on the GST alone would improve returns to the point where significant numbers of potential investors would likely be attracted to building new rental projects. Further reductions in costs would result in further improvements in the attractiveness of rental investment - and would lead to further construction.

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Introduction

The report *Responding to the Challenge: The Economics of Investment in New Rental Housing in 1999*, prepared by the author on behalf of the Ontario Ministry of Municipal Affairs and Housing (MMAH) in February 1999 provided an examination of the potential returns from investment in new rental housing in Toronto. The report was an update of the analysis in a previous report, *The Challenge of Encouraging Investment in New Rental Housing in Ontario*, prepared by the author for the MMAH in 1995.

The main findings of the *Responding to the Challenge* report were that the attractiveness of investment in new rental housing had improved considerably since 1995. The chief factors behind the improvement in the economics of rental investment were:

- The *Tenant Protection Act* (TPA) - the Province replaced the very strict rent control regime in the province with a more balanced approach which provides protection for sitting tenants while allowing landlords to charge market rents for vacant rental units.
- More equitable property taxes for rental housing - previously, rental projects paid roughly double the property taxes paid on similar owner-occupied accommodation.
- Lower interest rates - at the time the report was prepared, rental buildings could obtain 10-year CMHC-insured mortgage financing at 5¾% - well below the 8% rates at the time of the 1995 report. (Subsequently, rates have increased to the 7% range.)

As a result of these and other factors, the report concluded that it was likely that there would be some new rental housing construction in Toronto. The report indicated that most of the new rental housing built would likely be targeted at the high end of the market and that the main developers of these projects would likely be companies which already owned and managed rental properties and those that already owned suitable land. The report concluded that it was unlikely the potential returns from rental construction would be sufficient to attract merchant builders who would build projects and then sell them to property investors. It also identified a number of additional measures which could improve the prospects for rental construction.

This report updates and builds on the analysis contained in the *Responding to the Challenge* report. Commissioned by the Rental Housing Supply Alliance, the report has two main goals:

- Examine changes in the economics of new rental investment since the preparation of the *Responding to the Challenge* report, and identify the implications of these changes on the likely volume of new rental investment in Toronto; and
- Examine the impacts of potential government initiatives to encourage investment in new rental housing.

The next two sections of the report deal with these two goals. The final section presents the conclusions of the analysis.

Exhibit 1: Rental Apartment Vacancy Rates - Major Canadian Centres

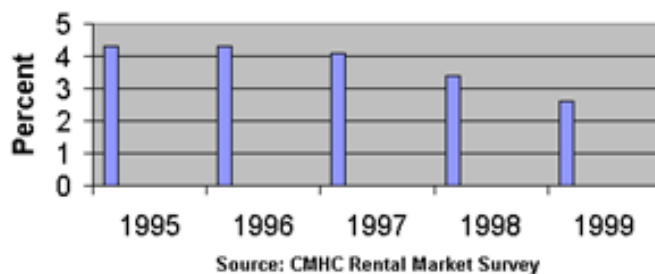
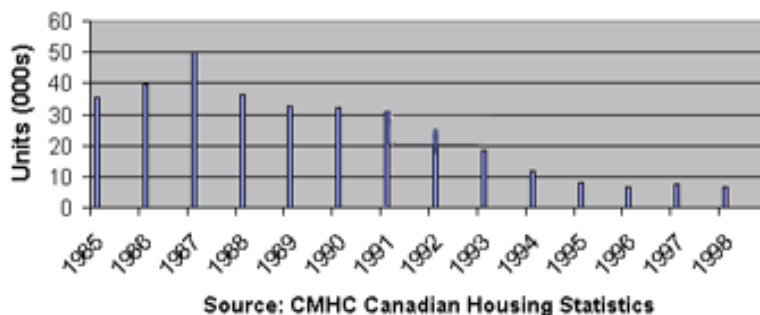


Exhibit 2: Rental Starts - Centres of 10,000+, Canada 1985-1998



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2. Changes in the Rental Investment Environment Since Early 1999

Since the preparation of *Responding to the Challenge*, there have been a number of

changes which affect the environment for rental investment. The key changes include:

- Tightening rental markets
- Higher rents
- Higher interest rates
- Higher development costs
- Improved CMHC underwriting criteria for new rental housing

Rental Markets Tightening Across Canada

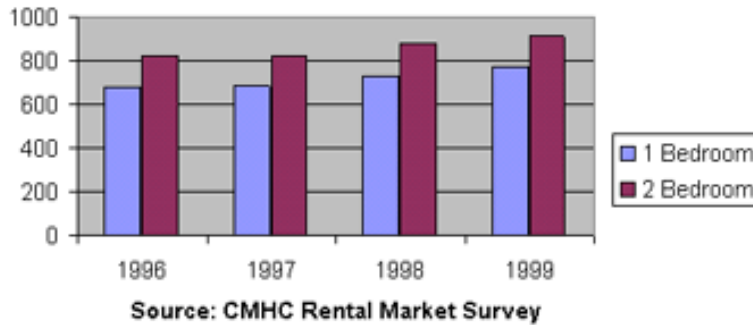
The recently released results of the annual CMHC Rental Market Survey indicate a significant tightening in rental markets across the country. The average vacancy rate for the 25 major metropolitan areas in Canada (Census Metropolitan Areas or CMAs) dropped from 3.4% in October 1998 to 2.6% in October 1999. A vacancy rate of 2.6% is within the 2-3% range that most housing analysts consider indicative of a reasonably balanced rental market; however, there are a number of major markets which have vacancy rates well below this level:

- Ottawa has the lowest vacancy rate in the country at 0.7% - down from 2.1% in 1998 - due to the strong local economy.
- The Toronto market has the next lowest vacancy rate (0.9%) - up slightly from 0.8% in 1998. The Toronto rental market has been very tight since the early 1990s and rents are rising significantly.
- Markets near Toronto are tightening as well: Kitchener's vacancy rate was 1.0% (down from 1.5%) and Oshawa and Hamilton both had large decreases in vacancy rates to 1.7% and 1.9% respectively.
- Both Saskatoon and Regina also have low vacancy rates (0.9% and 1.4%, respectively).

Most other parts of Canada have balanced or oversupplied rental markets but, in most cases, vacancy rates are declining due to the combination of higher demand (resulting from the strengthening economy) and little new rental construction. Montreal's vacancy rate declined to 3.0% in October, the lowest in over a decade. Similarly, Halifax dropped to 3.6%, the lowest it has been since 1990/ Vancouver's vacancy rate remains relatively high (2.7%) due to the weak economy in BC. Calgary was one of the few markets in which vacancy rates increased - 2.8%, as a result of a slowdown in demand and an influx of condominium completions.

There has been little new rental construction in Canada in recent years. In 1998, there were only 6,500 rental units started - this is well below the levels of the 1980s and early 1990s and nowhere near the levels of the 1960s and early 1970s when the baby boom generation was entering the prime renting age groups. Demand for new rental housing is lower now than during this period; however, it is still substantial - CMHC projects a demand for an additional 40,000-62,000 rental units annually across the country during the period to 2006. While some of these required rental units will come from 'non-conventional' sources (e.g. basement apartments and rented condominiums), such supply can, at best, only supplement the supply of conventional purpose-built rental housing. Without new conventional rental supply, vacancy rates will tighten further.

Exhibit 3: Average Apartment Rents - Toronto CMA, 1996-1999



Part of the reason for the downturn in rental construction since the early 1990s has been the withdrawal of federal and provincial government funding for new social housing projects. The substantial social housing programs of the 1980s and early 1990s buoyed overall rental production. The social housing completions masked the reduction in private rental investment, as well as the fact that such investment had become unviable. Ultimately, the unsustainable costs of the social housing programs led to their termination. However, with little private rental construction, the inevitable result is tightening rental markets. This is likely to lead to lower vacancy rates in the next few years - particularly in markets with strong economies.

Rents are Rising

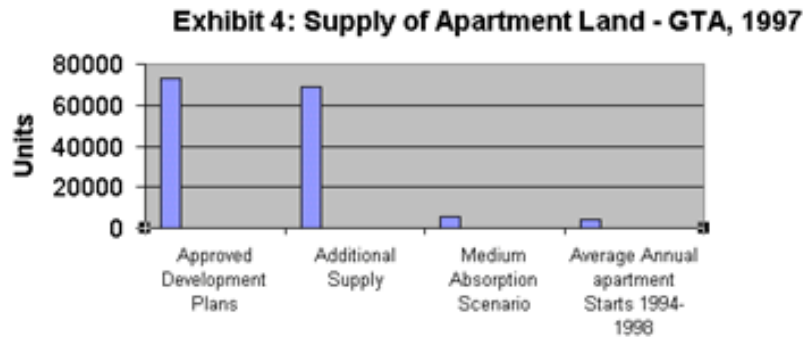
Inevitable, with tighter rental markets, rents are rising - in some cases significantly. In Toronto, for example, as noted by CMHC:

"Overall rents in 1999 increased by 4.6%, greater than the Rent Review Guideline allowable increase of 3%, but lower than last year's 6.9% jump.

...In general, a tight Toronto rental market has resulted in higher rents. Changes in the *Tenant Protection Act* (TPA) allow market rents to be charged on newly vacated units. This new environment has led to significant rent increases on some units, further increasing the overall rent. The smaller increase in 1999 was caused by fewer renters switching apartments thereby limiting the number of units where market rents could be charged. It is also suspected that overall rent increases are smaller this year because more units, especially in high demand areas, are at their legal maximum thereby limiting rent increases." ¹

The inevitable conclusion from this analysis is that rents will continue to rise significantly in Toronto as long as tight rental markets prevail. With little new rental construction and a strong local economy, there is little prospect for a softening in the Toronto rental market in the foreseeable future. As will be seen later in this report, the increase in market rents in Toronto is one of the few changes since the preparation of the *Responding to the Challenge* report in February that is positive in terms of the economics of new rental investment - though this is obviously not positive for tenants.

In other centres with tight rental markets, rents have also risen - though, in most cases, not to the same extent as in the Toronto market. However, additional rent increases are also likely in these markets as they tighten further due to the lack of new supply and the strong demand resulting from the growing economy.



Source: CMHC(Starts), and Ministry of Municipal Affairs and Housing, GTA Residential Land Inventory

Higher Interest Rates

Mortgage interest rates are typically tied to the yield on the Government of Canada bond for similar terms. At the time of the preparation of *Responding to the Challenge* report, 5-10 year Canada bond yields were in the 4.8-5% range. Allowing for the 50-70 basis point spread which applied for large projects such as rental apartment buildings, the interest rate on the CMHC-insured rental project mortgage was estimated at 5½-5¾%. For the pro forma analysis of the economics of the various types of rental projects contained in that report, a 5¾% mortgage interest rate was assumed.

Over the period since the report was prepared, interest rates have increased significantly in Canada. The 5-10 year Canada bond yield is currently in the 6% range. At the same time, spreads on CMHC-insured mortgages have increased to 80-100 basis points above the Canada bond yield. Allowing some premium to 'lock-in' the rate until project completion, it seems likely that a 1-year mortgage rate on a good quality rental project would be in the 7% range.

Higher Construction Costs

With the downturn in the volume of construction in Toronto following the boom of the late 1980s, construction costs dropped significantly. Apartment construction costs were relatively stable during the 1991-1996 period but began to increase substantially in 1997 as a result of a resurgence in condominium sales. They increased further in 1998 and, so far in 1999, according to industry sources, construction costs are up 8-10% from the beginning of the year.

Abundant Supply of Multiple Land - But High Prices in Good Location

There is no shortage of developable multiple land in the Greater Toronto Area (GTA). Exhibit 4 (from the *Responding to the Challenge* report) presents estimates of the supply of apartment land from the Ministry of Municipal Affairs and Housing and CMHC. According to these estimates, in 1997 there were:

- 72,985 units of apartment land in approved development plans (draft approved or registered); and
- A further 69,190 units of 'additional supply' - units waiting for final official plan amendment, rezoning or draft plan approval.

Many of these units were in suburban locations (particularly Peel); however, many were in

built-up areas which can be considered 'ripe for development/redevelopment'. Of the total supply of over 142,000 apartment units, 56,000 were in redevelopment sites (i.e. in built-up areas) - 48,500 of these units were in the new City of Toronto.

Given the volume of apartment activity in Toronto (an average of only just over 4,000 starts annually during the 1994-1998 period, and 5,500 annually in the future, according to CMHC's medium absorption scenario), it is evident that there is a more than ample supply of land for rental development. As a result, there are likely many owners of multiple land in the GTA who, in the absence of development alternatives for their land, might be motivated to consider building rental housing. For many landowners, this may be more attractive than leaving the site vacant for the indeterminate future (with taxes and interest charges accruing annually), or selling the site for condominiums, thereby triggering taxes on the disposal of long-held low-cost land.

While there may be an abundant supply of multiple land, it still carries a hefty price in good locations. With the upturn in condominium development over the past few years, and the potential prospect for viable new rental development, multiple land values have increased in the GTA. For choice multiple housing development sites, such as those in the downtown core, there is competition among developers - and correspondingly higher prices.

Improved CMHC Underwriting Criteria for Rental Housing

The *Responding to the Challenge* report identified a number of measures which the government could take to facilitate investment in new rental housing. One of the more important measures was the need for CMHC to reexamine its underwriting practices to recognize the actual value of new rental projects for the purposes of underwriting mortgage insurance.

In the mid-1990s, CMHC introduced very restrictive underwriting criteria for mortgage insurance on rental projects, as well as much higher premiums, because of previous losses in the Corporation's portfolio of rental mortgages. The mortgage insurance premiums effectively doubled, and the restrictive underwriting criteria had the effect of limiting the size of rental mortgages to well below the levels which rental investors would be seeking. The restrictive criteria included the use of a 9% capitalization (cap) rate, and a debt coverage ratio of 1.1 based on a 9% mortgage interest rate, rather than market cap and mortgage rates - as well requirements for covenants and personal guarantees from the owners of rental projects. At the time these new criteria were introduced, both cap rates were much higher than today. In 1999, with cap rates of 7-8% in strong rental markets (such as Toronto), and mortgage rates well below 9%, the CMHC underwriting criteria unnecessarily restricted the amount of mortgage financing which could be obtained for rental housing projects.

As discussed in the *Responding to the Challenge* report, CMHC's use of restrictive underwriting criteria for new rental housing projects was a severe impediment to rental investment since investors were required to put up a much larger equity investment than might otherwise have been necessary.

In 1998, CMHC announced a change in their underwriting criteria for existing rental projects which recognized market cap rates and market mortgage rates, rather than the previously (much higher) prescribed rates. While there has been no official announcement of similar changes with respect to underwriting for new rental projects, CMHC has unofficially indicated that they will apply flexible criteria (read market cap and mortgage rates) in valuing new projects for underwriting purposes. This is a welcome change which will enhance the economics of investment in new rental housing.

**Exhibit 5:
Pro Forma
High-End High-Rise Rental Project**

Downtown Toronto
(\$ per unit)

	February Report	Current Situation
Development Costs and Financing		
Land	33,257	35,806
Construction	117,565	126,500
GST	<u>10,558</u>	<u>11,361</u>
Project Costs	161,380	173,667
Equity	50,562	38,147
Financing	110,818	135,520
Mortgage Insurance Fee	<u>3,325</u>	<u>4,060</u>
Mortgage	114,142	139,586
First Year Revenues, Costs and Cash Flow		
Revenues	17,300	18,480
Maintenance & Operations	3,100	3,160
Property Taxes	<u>1,733</u>	<u>1,768</u>
Total Operating Costs	4,833	4,928
NOI	12,467	13,552
Mortgage Payments	7,520	10,584
Cash Flow	4,947	2,968
Cash on Cash Return	9.8%	7.8%
Cap Rate	7.7%	7.8%

Economics of Rental Investment Have Worsened Since February

As a result of the cumulative effect of the changes discussed above, the economics of rental investment in Toronto have worsened since the preparation of the *Responding to the Challenge* report in February. Exhibit 5 presents a comparison of the pro forma for an average unit in a high-end high-rise rental project in downtown Toronto (From Exhibit 3-11, page 28 in the February report) with how the pro forma would look today, given the changes in the interim period. The high-end rental project in downtown Toronto is used here to illustrate the changes in the economics of rental investment since it is the type of project which the February report concluded offered the most attractive prospects for investors.

Comparing each of the factors presented in Exhibit 5 in turn:

- **Land costs** - revised estimates of land costs for the high-end unit were obtained from Lyon Consultants. They estimated a base cost of \$32,000 per unit for the land. Adding the parkland dedication (5% or \$1,600), the new City development charge (\$1,131)² and the 'public art' charge of \$1,075 (1% of the hard construction cost)

brings the total land cost to \$35,806. This compares with \$33,257 in February.

- **Construction costs** - construction costs have increased significantly since earlier this year estimates vary, but it appears that hard construction costs are up by 8-10% or more, depending on the nature of the project. For the purposes here, it is assumed that hard construction costs for this project are \$107,500 (8% higher than in February) and that soft costs are \$19,000 - therefore, the total construction costs are \$126,500. This compares with \$117,565 in February.
- **GST** - GST is assumed to be 7% of total development costs - \$11,361. This could actually understate the amount of GST owing on the project since Revenue Canada is apparently attempting to value rental projects at their 'highest and best use' for GST purposes - in this case, that use would be as 'for sale' condominiums which would likely have a much higher value.
- **Revenues** - as a result of the tight Toronto rental market and decontrol of vacant rental units, rents have risen significantly in the past year. The estimated monthly market rents for the high-end units are \$1,425 for the 1-bedroom units (800 square feet) and \$1,750 for the 2-bedroom unit (1,000 square feet) - roughly \$1.75 per square foot per month. With a 3% vacancy allowance, this yields average annual revenues of \$18,480 per unit. This compares with \$17,300 in February.
- **Net operating income** - due to higher rents on the project (less the inflationary increase in operating costs), NOI is higher - \$13,552. This is very important for the financing of the project since NOI forms the basis for the determination of lending value by CMHC - and, ultimately, the size of the mortgage.

Exhibit 6:

Cash on Cash Returns and Cap Rates

Selected Rental Projects, December 1999

	Cash on Cash Return	Cap Rate
Downtown Toronto		
High-End, High-Rise	7.8%	7.8%
Medium, High-Rise	7.1%	7.6%
Large Suite, Low-Rise	6.8%	7.6%
Mississauga		
Large Suite, Low-Rise	5.9%	7.2%

- **Project financing** - with the higher NOI, plus the revisions to CMHC mortgage insurance underwriting criteria, the project is able to carry a larger mortgage. Using an 8% cap rate and an 80% loan to value ratio, the mortgage (including the mortgage insurance fee) totals \$139,586 - well above the \$114,142 in mortgage financing in February. The change in CMHC's underwriting criteria is very beneficial to the economics of the project since it allows the investor to leverage more of the project cost and reduce the size of the equity contribution to \$38,147 - well below the \$50,562 in February (though this higher mortgage amount would trigger requirements for increased borrower credit support). Unfortunately, as discussed, the mortgage must be financed at 7% rather than at the 5¾% mortgage rate which prevailed in February (due to the increases in interest rates in the intervening period).
- **Mortgage payments** - with the higher mortgage amount plus the higher mortgage interest rate, the mortgage payments are considerably higher - \$10,584 compared to \$7,520.
- **Cash flow** - the cash flow from the project is much lower than in February (\$2,968 versus \$4,947); however, in terms of assessing the viability of the project, this lower cash flow is offset to some extent by the reduced equity resulting from the increased

leverage on the project. The cash on cash return is 7.8% - well below the 9.8% in February.

The project is clearly a less attractive investment now than it was in February. The cap rate (NOI/total development costs) is 7.8%, slightly higher than the 7.7% in February; however, the cash on cash returns are much less. Few developers would find this return attractive.

Returns from Other Types of Rental Projects Also Less Than in February

As part of the background research for this report, updated pro formas were prepared for three other rental projects used in the *Responding to the Challenge* report. These three projects included:

- Medium quality high-rise rental project in downtown Toronto;
- Medium quality large suite low-rise rental project in downtown Toronto; and
- Medium quality large suite low-rise rental project in Mississauga.

These projects were selected for this updated analysis because (in the case of the downtown Toronto projects) the February report indicated that they were close to being economically attractive. The Mississauga project was selected to demonstrate the economics of rental investment in a suburban location. Details behind the characteristics of these projects are provided in the original report. A summary of the updated pro formas for each of these projects is provided in the appendix to this report.

Exhibit 6 presents a summary of the estimated cash on cash returns and cap rates which would apply to each of these types of projects today. In none of the cases is the rental project likely to be attractive to a rental investor. In all cases, the returns (both the cap rates and the cash on cash returns) are less than those for the high-end high-rise project in downtown Toronto (from Exhibit 5). This mirrors the findings of the February report, though in all cases, the project economics were better in February than they are today.

The returns from suburban rental development are particularly poor. As illustrated by the example of a low-rise rental project in Mississauga, the current cash on cash return from such developments is hampered by the very high development charges which apply in suburban municipalities in the GTA. In Mississauga, the development charges on an apartment unit with 750+ square feet total \$11,162. This clearly reduces the potential returns from such investments.

Conclusion - Little Rental Investment Likely

Based on the foregoing analysis, it is unlikely that there will be a significant volume of rental construction in Toronto for the foreseeable future. The economics of rental investment have worsened since the completion of the *Responding to the Challenge* report in February and, unless there is a substantial change in terms of either improved revenues (i.e. higher rents) or reductions in costs and/or interest rates, it is unlikely that there will be much new rental construction in Toronto. While there may be a few projects built (e.g. by developers who have land which is not suitable for condominium development for some period), they will predominantly be targeted at the high-end of the market, where the economics come closest to being attractive.

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3. Effects of Potential Government Initiatives on the Economics of Rental Investment

This section reviews the effects of potential government initiatives on the economics of investment in rental housing in Toronto. The initiatives examined include:

- Rescind the punitive treatment of rental housing by the GST; and
- Reduce other taxes and government charges.

These potential initiatives have been proposed by the Rental Housing Supply Alliance as a means of encouraging investment in new rental housing projects. The effects of each of these on the economics of rental development for the sample Toronto rental development for the sample Toronto rental housing projects are examined below.

Exemption from GST - Treat Rental Housing in Same Way as Commercial Development

The most obvious initiative available to the federal government is to treat rental housing the same as other types of commercial development. Owners of rental housing are subject to punitive GST treatment on the development of new projects and are denied input tax credits on operating costs. Unlike rental housing landlords, the owners of other types of commercial projects effectively do not pay GST - they receive full input credits for all GST paid.

Exhibit 7: Pro Forma High-End High-Rise Rental Project Downtown Toronto (\$ per unit)

	Base Case	Zero GST
Development Costs and Financing		
Land	35,806	35,806
Construction	126,500	126,500
GST	<u>11,361</u>	<u>0</u>
Project Costs	173,667	162,306
Equity	38,147	25,206
Financing	135,520	137,100
Mortgage Insurance Fee	<u>4,066</u>	<u>4,113</u>
Mortgage	139,586	141,213
First Year Revenues, Costs and Cash Flow		
Revenues	18,480	18,480
Maintenance & Operations	3,160	3,002
Property Taxes	<u>1,768</u>	<u>1,768</u>
Total Operating Costs	4,928	4,770
NOI	13,552	13,710
Mortgage Payments	10,584	10,707

Cash Flow	2,968	3,003
Cash on Cash Return	7.8%	11.9%
Cap Rate	7.8%	8.4%

This difference between the GST treatment of residential rental housing and commercial development is not clearly understood. It arises from the fact that, when the GST was introduced, a decision was made not to apply the GST to residential rents. Since commercial rents are subject to the GST, any GST paid on inputs by the owners of non-residential properties can be deducted against the GST collected from rents. In contrast, since residential landlords do not collect GST on rents, they are stranded with the GST they pay as there is no other GST collected on which it can be applied as a credit.

Therefore, residential rental owners pay GST (both on initial development value and on the expenses in on-going operations) while non-residential rental owners (e.g. companies with retail and office portfolios) do not.

Treating residential rental projects in the same way as non-residential projects would have a significant beneficial effect on the economics of new rental investment. Exhibit 7 demonstrates the impacts of the removal of GST from the high-end high-rise project in downtown Toronto:

- The elimination of the \$11,361 per unit of GST on the development costs of the project would result in a reduction in project costs to \$162,306. For a 200 unit project, the elimination of GST would reduce costs by almost \$2.3 million.
- In addition, to achieve parity with non-residential landlords, the GST paid on inputs to the operations of the project would also be eliminated. These have been estimated at 5% of the operating costs of a rental project.³ For the zero GST example in Exhibit 7, operating costs have been reduced to \$3,002 to reflect the removal of GST. This results in a higher NOI - which, in turn, leads to an increase in the eligible mortgage amount.
- The reduced project costs and the higher mortgage amount would result in a reduction in the required equity investment for the project, thereby making it much more attractive. For the high-end downtown Toronto project, the elimination of GST would reduce the required equity investment from \$38,147 to \$25,206 per unit.
- As a result, the cash on cash return on the invested equity rises from 7.8% to 11.9% - much closer to being attractive, especially for those who might have suitable land and/or property management operations which could accommodate the building with relatively little increase in costs.
- The cap rate for the project would be 8.4%. This level of return would likely be attractive to some companies which either own land or are building for their own portfolio - or both.

As discussed in Section 2, there is an ample supply of developable multiple land in the GTA and many owners who would likely be motivated to build if they could achieve a reasonable return. For the high-end high-rise project in downtown Toronto, for example, if the investor already owned the land (and it was unlikely to be developable for condominiums for some period, given the competition), the apparent cash on cash return would be much greater - since the land value would more than cover the equity required for the project. It would be a way for the owner to recoup some or all of the current investment in land.

However, the potential returns from the project would not likely be sufficient to attract merchant builders who would market the completed projects to long-term investors (such

as pension funds, REITs, etc.). As discussed in the *Responding to the Challenge* report (page 39), the pro forma analyses presented here do not allow for developer profit. Therefore, it is unlikely, with the current economics, that removal of the GST from rental housing would be sufficient to attract companies in the development business who are seeking to sell projects to an investor.

Therefore, elimination of the GST on rental housing would be extremely beneficial to the economics of rental investment. It would improve returns and would clearly result in additional new rental construction. However, as discussed, while it would improve the economics of rental investment, it is unlikely that it would be sufficient to attract merchant builders - unless they were developing on a low-risk pre-agreed sales basis to financial partners such as REITs or other investors.

Forgoing Other Taxes and Charges Could Encourage Additional Rental Investment

The Rental Housing Supply Alliance points out that, in addition to the GST, there are significant other taxes and charges which apply on new rental housing. As with the GST, elimination or reduction of these taxes and charges would have a beneficial effect on the economics of rental investment. These taxes and charges (and rough estimates of the appropriate amounts for one unit in the high-end high-rise building in downtown Toronto) include:

- Provincial sales taxes - payable on materials used in construction, these would total roughly \$3,500⁴
- Provincial land transfer tax - payable on the initial land purchase, this would total about \$640
- Municipal development charges - as noted in Section 1, development charges and the 'public art' charge total \$2,206⁵
- Municipal building permit and development application fees - these are estimated at roughly \$1,300⁶
- Municipal land dedications - as noted in Section 1, these are estimated at \$1,600
- Municipal property taxes during construction - these are estimated at roughly \$1,500.

Exhibit 8:
Pro Forma
High-End High-Rise Rental Project
 Downtown Toronto
 (\$ per unit)

	Base Case	Zero GST	Reduction in Other Taxes/Charges
Development Costs and Financing			
Land	35,806	35,806	35,806
Construction	126,500	126,500	126,500
GST	<u>11,361</u>	<u>0</u>	<u>0</u>
Project Costs	173,667	162,306	162,306
Lower Taxes/Charges	0	0	10,000
Revised Costs	173,667	162,306	152,306
Equity	38,147	25,206	15,206

Financing	135,520	137,100	137,100
Mortgage Insurance Fee	<u>4,066</u>	<u>4,113</u>	<u>4,113</u>
Mortgage	139,586	141,213	141,213
First Year Revenues, Costs and Cash Flow			
Revenues	18,480	18,480	18,480
Maintenance & Operations	3,160	3,002	3,002
Property Taxes	<u>1,768</u>	<u>1,768</u>	<u>1,768</u>
Total Operating Costs	4,928	4,770	4,770
NOI	13,552	13,710	13,710
Mortgage Payments	10,584	10,707	10,707
Cash Flow	2,968	3,003	3,003
Cash on Cash Return	7.8%	11.9%	19.7%
Cap Rate	7.8%	8.4%	9.0%

In total, therefore, these taxes and charges amount to over \$10,000. This excludes consideration of other types of charges such as CMHC's mortgage insurance fee, federal and provincial capital taxes, and other charges which add to the costs of building and operation new rental projects.

As illustrated in Exhibit 8, elimination or reduction of some or all of these taxes and charges would clearly enhance the economics of rental construction in Toronto. Combined with the elimination of GST, a reduction in taxes and charges equivalent to \$10,000 would increase both cash on cash return and the cap rate for rental projects. Highlights of Exhibit 8 include:

- In addition to the elimination of GST, a reduction in other taxes and charges of \$10,000 would reduce development costs to \$152,306 from the current situation of \$173,667. This has the effect of reducing the required equity in the project to \$15,206.
- Because of the reduction in the size of the required equity investment, the cash on cash return would improve to almost 20% - clearly substantially better than the current situation of 7.8%.
- The cap rate for the project also increases significantly - to 8.9% compared to the current cap rate of 7.8%.

This is clearly a much more attractive scenario for rental investment than currently applies.

If the reduced costs were reflected in a reduced mortgage (i.e. keeping equity at \$30,000 - roughly 20% of the revised development costs), the cash on cash returns would be reduced somewhat but would still be attractive. This option is not shown in Exhibit 8, however, the effect would be to reduce the mortgage to \$122,300, for an effective loan to value ratio of 72% (based on a cap rate of 8% applied to NOI). This would qualify the project for a reduced mortgage insurance fee of 2.5% (\$3,060). In total, the mortgage payments would be roughly \$9,500, so cash flow would be increased to \$4,200 - a cash on cash return of about 14% on the \$30,000 equity investment. For companies which already own the land, this would clearly be an attractive use of their investment - especially if the market potential for the alternative use of the land (e.g. condominium development) was likely years away from being realistic.

There is little doubt that the prospect of these types of returns would be sufficient to attract additional investors to private rental construction.

Reduced Charges Also Lead to Much Higher Returns from Medium Quality Rental Buildings

Exhibit 9 presents the effects of the elimination of the GST and rebates of other taxes and charges on the estimated cash on cash returns and cap rates for all four of the potential rental projects examined in this report - including both the high-end high-rise project (from Exhibit 8) and medium quality projects in downtown Toronto and Mississauga. More details behind these estimates are provided in the appendix.

Exhibit 9:
Cash on Cash Returns and Cap Rates
Zero GST, Reduction in Other Charges/Taxes
Selected Rental Projects, December 1999

	Cash on Cash Return			Cap Rate		
	Base Case	Zero GST	Charges/ Taxes	Base Case	Zero GST	Reduction in Other Charges/ Taxes
Downtown						
High-End, High-Rise	7.8%	11.9%	19.7%	7.8%	8.4%	9.0%
Medium, High-Rise	7.1%	10.6%	19.0%	7.6%	8.3%	9.0%
Large Suite, Low- Rise	6.8%	10.1%	18.2%	7.6%	8.2%	8.9%
Mississauga						
Large Suite, Low- Rise	5.9%	7.9%	14.1%	7.2%	7.8%	8.7%

Highlights of Exhibit 9 include:

- Elimination of the GST has a very beneficial impact on the economics of all of the new rental projects. From a base case cap rate of 7.2-7.8% for the four projects, elimination of the GST raises the cap rate roughly 0.6 percentage points to the 8.2-8.4% range for the Toronto projects. The cap rate (and overall returns) for the Mississauga project are much less - mainly due to the high development charges in Mississauga (and other suburban areas of the GTAA).
- In terms of cash on cash return, the elimination of the GST raises returns to the 10+ % range for the three Toronto projects. For the Mississauga project, the cash on cash return is 7.9%.
- Further reductions in charges and taxes could clearly have an even more beneficial effect on the economics of rental investment. A reduction of \$10,000 in other taxes and charges would raise the cap rates for all of the projects to the 8.7+ % range - sufficient to be attractive to a range of investors.

Clearly, this analysis demonstrates that action by governments in reducing or eliminating taxes and charges that apply to new rental development would enhance the attractiveness of private rental investment and could be effective in stimulating the much-needed construction of rental projects. Also, the improved economics would likely extend beyond the high-end rental market in downtown Toronto to include other types of rental projects in other parts of the GTAA.

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4. Conclusion - Reductions in Taxes and Charges Would Enhance Prospects for Rental Construction

The attractiveness of rental investment has eroded since the preparation of the *Responding to the Challenge* report in February 1999. That report concluded that there was a good prospect for new rental construction in Toronto - based on the economics of rental investment at that time. Since then, the prospect of significant new rental investment has receded due to higher interest rates and higher development costs. These have more than offset the beneficial effects on investment from higher market rents and revised CMHC mortgage insurance underwriting criteria.

What could be done to further enhance the prospects for rental investment? The *Responding to the Challenge* report identified a number of initiatives which governments could pursue to encourage new private rental construction. Of these, two have been addressed:

- **CMHC mortgage insurance** - as discussed in Section 2, CMHC underwriting criteria for new rental projects have been adjusted to reflect the market realities for Toronto. This is very beneficial for new rental investment.
- **Special property tax for new rental construction** - the City of Toronto has designated a special class for new rental projects which will apply for 8 years following the completion of a rental project as allowed under the Province's 1997 *Fair Municipal Finance* legislation. This could provide an alternative for rental investors who, as discussed in the February report, would likely register their buildings as condominiums in order to obtain the favorable property tax treatment accorded single-family and condominium developments. The specifics of the property taxes which will apply to the special property tax class are still not finalized so it is uncertain whether they will provide an attractive alternative to condominium registration of rental projects.

In addition, the Ontario government has announced the Provincial Sales Tax Grant Program "to stimulate the construction of affordable rental housing in the province". Grants of \$2,000 per unit are available for 'affordable' rental buildings completed in the period to 2002. There is a severe restriction on the unit sizes for the buildings eligible for the program - 650 square feet for a 1-bedroom unit and 850 square feet for a 2-bedroom unit. These are smaller than the high-end and medium quality units used in the analysis in this report, and in the *Responding to the Challenge* report. The restriction on program eligibility to very small units is unfortunate since it disqualifies the types of rental buildings which are closest to being economically attractive as investments (i.e. high-end and medium quality units).⁷ It seems unlikely that there will be significant take-up of the Provincial Sales Tax Grant Program by private rental investors.

The other important potential initiatives to improve the economics of rental investment which were identified in the *Responding to the Challenge* report, but which have not been

addressed, included:

- **GST** - the GST is clearly now the most significant impediment to new rental construction. The GST collects more than three times as much in federal sales taxes as the old Manufacturers Sales Tax which it replaced. It also discriminates against residential rental construction since the owners of new commercial buildings effectively do not pay any GST. It is difficult to see how the federal government can justify this punitive treatment of rental construction- especially with the looming shortages of rental accommodation in major cities across Canada.
- **Development charges and other municipal charges** - Toronto has imposed a development charge on new rental apartment projects which will reach \$1,692 and \$2,644 for 1-bedroom and 2-bedroom units, respectively, in 2001. There is a phase-in period prior to the introduction of the full development charge. In suburban municipalities, development charges are much higher - in Mississauga, for example, the development charges for apartment units of 750 square feet or more total \$11,162. In addition, there are a variety of other municipal fees and charges which apply to new development. These all add to costs and serve to discourage new rental construction.

As illustrated in Section 3 of this report, elimination of the GST and reductions in other taxes and charges would have a very beneficial effect on the economics of rental investment. Elimination of the GST alone would improve returns to the point where significant numbers of potential investors would likely be attracted to new rental construction. Further reductions in costs would result in further improvements in the attractiveness of rental investment - which would lead to further rental construction.

The Rental Housing Supply Alliance also supports a reexamination of the income tax regulations as they affect rental housing. Changes such as accelerated depreciation for rental projects, or allowing rental owners to shelter capital gains taxes on the sale of older rental projects provided they are replaced with new projects, would likely encourage investors to accept a lower return on rental projects than they would under the current tax regime.

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Appendix

Summary Pro Formas for Selected Rental Projects

This appendix presents summary pro formas for the three rental projects not discussed in detail in the main body of the report. These three projects are:

- Medium quality high-rise rental project in downtown Toronto;
- Medium quality large suite low-rise rental project in downtown Toronto; and
- Medium quality large suite low-rise rental project in Mississauga.

Detail behind these projects are available from the Responding to the Challenge report prepared in February 1999 - pages 13-33 in the main body of the report and Appendices A-D. For the pro formas presented here, rents and land costs were updated based on information provided by Lyon Consultants. In addition, the construction cost estimates presented in the February report were raised by 8% for hard costs and 6% for soft costs.

The estimated operating costs and property taxes were raised by 2% from those prepared in February.

The projects are all assumed to obtain 80% CMHC-insured mortgages amortized over 35 years at a mortgage rate of 7%. In all cases except the Mississauga project, it is assumed that CMHC applies an 8% cap rate in determining the value of the project for lending purposes. In the case of the Mississauga project, the cap rate is assumed to be 8 1/2%.

The key findings of these pro formas (cash on cash return and cap rates) are provided in Exhibits 6 and 9 in the main body of the report.

Exhibit A-1:
Pro Forma
Medium High-Rise Rental Project
 Downtown Toronto
 (\$ per unit)

	Base Case	Zero GST	Reduction in Other Taxes/Charges
Development Costs and Financing			
Land	25,806	25,806	25,806
Construction	105,674	105,674	105,674
GST	<u>9,204</u>	<u>0</u>	<u>0</u>
Project Costs	140,684	131,480	131,480
Lower Taxes/Charges	0	0	10,000
Revised Costs	140,684	131,480	121,480
Equity	33,194	22,560	12,560
Financing	107,490	108,920	108,920
Mortgage Insurance Fee	<u>3,225</u>	<u>3,268</u>	<u>3,268</u>
Mortgage	110,715	112,188	112,188
First Year Revenues, Costs and Cash Flow			
Revenues	14,987	14,987	14,987
Maintenance & Operations	2,856	2,713	2,713
Property Taxes	<u>1,382</u>	<u>1,382</u>	<u>1,382</u>
Total Operating Costs	4,238	4,095	4,095
NOI	10,749	10,892	10,892
Mortgage Payments	8,395	8,506	8,506
Cash Flow	2,354	2,386	2,386
Cash on Cash Return	7.1%	10.6%	19.0%
Cap Rate	7.6%	8.3%	9.0%

Exhibit A-2:
Pro Forma
Large Low-Rise Rental Project
Downtown Toronto
(\$ per unit)

	Base Case	Zero GST	Reduction in Other Taxes/Charges
Development Costs and Financing			
Land	25,806	25,806	25,806
Construction	99,052	99,052	99,052
GST	<u>8,740</u>	<u>0</u>	<u>0</u>
Project Costs	133,598	124,858	124,858
Lower Taxes/Charges	0	0	10,000
Revised Costs	133,598	124,858	114,858
Equity	32,598	22,328	12,328
Financing	101,000	102,530	102,530
Mortgage Insurance Fee	<u>3,030</u>	<u>3,076</u>	<u>3,076</u>
Mortgage	104,030	105,606	105,606
First Year Revenues, Costs and Cash Flow			
Revenues	14,696	14,696	14,696
Maintenance & Operations	3,060	2,907	2,907
Property Taxes	<u>1,536</u>	<u>1,536</u>	<u>1,536</u>
Total Operating Costs	4,596	4,443	4,443
NOI	10,100	10,253	10,253
Mortgage Payments	7,888	8,007	8,007
Cash Flow	2,212	2,246	2,246
Cash on Cash Return	6.8%	10.1%	18.2%
Cap Rate	7.6%	8.2%	8.9%

Exhibit A-3:
Pro Forma
Large Low-Rise Rental Project
Mississauga
(\$ per unit)

	Base Case	Zero GST	Reduction in Other Taxes/Charges
Development Costs and Financing			
Land	17,462	17,462	17,462
Construction	87,287	87,287	87,287
GST	<u>7,332</u>	<u>0</u>	<u>0</u>

⁷ The restriction of the Provincial Sales Tax Grant Program to small "affordable" rental units clearly is aimed at stimulating construction of modest rental units - presumably to serve tenants with modest incomes. While this is a laudable goal, the restriction is unfortunate since it overlooks the fact that new rental supply (any new rental supply) is beneficial to the rental market. By absorbing some of the growing demand for rental accommodation, new supply (at the high-end of the market) results in vacancies in the other parts of the rental stock which would not have occurred if these buildings were not built. High-end buildings absorb high-income tenants who, if the buildings were not available, would occupy rental units in the existing stock. By absorbing such tenants, new buildings create a 'supply' of existing rental units to by other tenants seeking rental accommodation. See pages 45-46 of the Responding to the Challenge report for a discussion of the importance of new rental supply (even high-end supply) to tight rental markets such as Toronto.