The Economics of New Purpose-Built Rental Housing Development in Selected Canadian Markets

THE RESEARCH

CMHC commissioned a research project to assess the general economics of developing purpose-built rental apartments in six of Canada's major markets: Vancouver, Calgary, Winnipeg, Toronto, Montréal and Halifax. The project was undertaken to provide insight on some of the current factors that can influence investors' and developers' decisions to fund purpose-built rental housing projects.

OVERVIEW

The analysis used a pro forma framework to provide insight on the factors influencing the economics of new purpose-built rental apartment building projects. A total of 12 pro formas were developed, representing a variety of selected building typologies for new rental apartment buildings in each of the aforementioned markets, based on a combination of variables:

- Type of project/location—three options (basic, medium and high-end, based on a combination of quality of construction and finishes, suite mix and location).
- Rents—two options (achievable market rents vs. required economic rent to make the project financially viable).
- Land costs—two options (market land costs vs. zero land costs).

All scenarios assumed CMHC mortgage loan insurance was provided and that projects had an 85% loan-to-value ratio. Assumptions for vacancy rates and real income growth were developed to be specific to each market.

FAST FACTS

Cash-on-cash returns on the private rental apartment building developments modelled were typically negative—even if land cost was assumed to be zero.

Economic rents were found to be generally above achievable market rents for the apartment building typologies modelled.

Here are some comparisons of per-unit cost (including land) to construct some of the buildings modelled:

- $174,000 for a basic project in Montréal vs. $236,000 in Vancouver.
- $285,000 for a medium project in Halifax vs. $299,000 in Winnipeg.
- $346,000 for a high-end project in Calgary vs. $370,000 in Toronto.

Intensification of existing sites could have more economic potential in Toronto and Vancouver, which are high land cost markets.

What is a pro forma?

A pro forma is a spreadsheet tool that summarizes the financial performance of an investment over a given time period. In the case of rental apartment development, the key areas of the pro forma include:

- Development costs (construction costs, land costs, HST/GST, etc.)
- Financing details (loan-to-value ratio, mortgage rate, amortization, mortgage loan insurance, etc.)
- Annual revenues (rents, other income, etc.)
- Annual operating expenses

What is "cash-on-cash return"?

Annual revenues, less operating costs and mortgage payments, divided by the initial cash investment, expressed as a percentage.

KEY FINDINGS

- For the rental apartment buildings modelled, the 10-year average annual cash-on-cash returns were found to be negative in most cases when land costs were included in the analysis. The exception was the basic project in Toronto. Toronto's relative advantage was due to a higher rent structure relative to costs, as well as relatively low property tax rates.
- Even with land costs assumed at zero, most markets and project types still exhibited a negative 10-year return. The key exception was that 10-year returns looked reasonably favourable for the basic projects in Vancouver and Toronto (figure 1).
- Economic rents necessary for a reasonable 10-year average cash-on-cash return (in the 10% per year range) on the projects modelled were typically well above achievable market rents. The premiums over market rents ranged from 11% in Toronto to 75% in Halifax, when accounting for land costs (figure 2).

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Table 1: Comparison of Development Costs for Apartment Building Typologies Modelled

	With land costs			Without land costs		
	Basic Project 50 Units	Medium Project 100 Units	High-End Project 150 Units	Basic Project 50 Units	Medium Project 100 Units	High-End Project 150 Units
Total rounded to the nearest $500						
Vancouver	$236,500	$335,500	$403,000	$164,500	$227,500	$259,000
Calgary	$216,000	$304,000	$346,000	$183,000	$263,000	$296,000
Winnipeg	$217,500	$299,000	$330,500	$203,500	$281,000	$302,000
Toronto	$211,000	$300,500	$370,000	$177,000	$250,500	$303,000
Montréal	$174,000	$243,500	$287,000	$164,000	$228,500	$268,000
Halifax	$190,000	$285,000	$329,000	$163,000	$249,000	$284,000
Per Square Foot						
Vancouver	$394	$559	$672	$274	$379	$432
Calgary	$313	$441	$501	$265	$381	$429
Winnipeg	$282	$388	$429	$264	$365	$393
Toronto	$301	$429	$529	$253	$358	$433
Montréal	$242	$338	$399	$228	$317	$372
Halifax	$253	$380	$439	$217	$332	$379

Figure 1: Average annual 10 year cash-on-cash returns, private rental

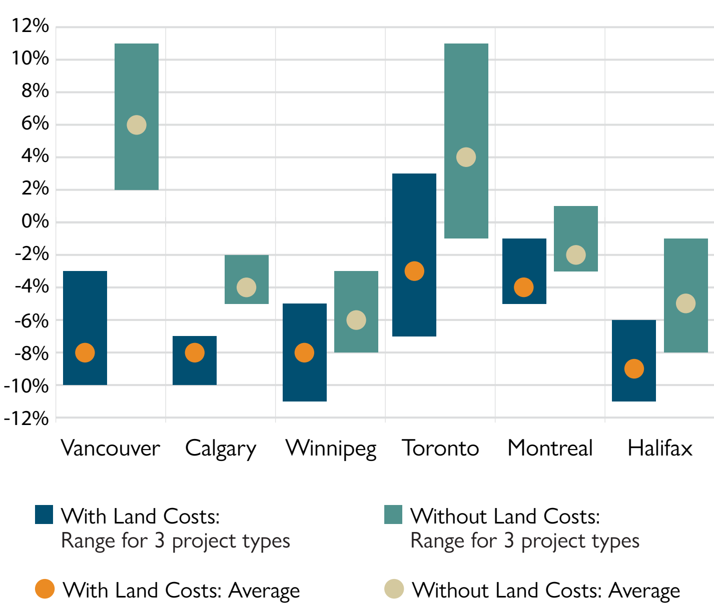
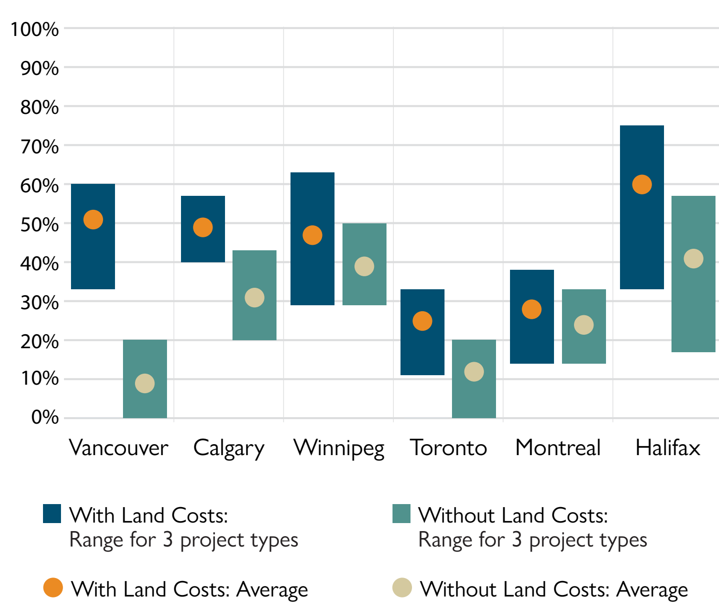


Figure 2: Economic rent premium over achievable market rent, private rental



IMPLICATIONS

The analysis sheds light on cost components and sensitivities in rental project construction and operation, and on the potential returns on investment, given diverse market conditions across Canada. The analysis also showed that there were low cash-on-cash returns for the new rental unit development typologies modelled in major markets. However, this does not mean that no rental unit development will take place in the current investment environment. In fact, purpose-built rental unit development has been exhibiting some increases in recent years, although it is still well below demand levels in key markets.

The analysis undertaken was illustrative of a "typical" situation that a developer may face, given prevailing market conditions. As has been the case in the past, individual developers may find rental investment attractive under specific circumstances. For example:

- If they have land acquired years earlier that they are willing to develop, rather than sell at market value, or they have a site that can be intensified (e.g. a retail site, or excess land on an existing rental site).
- If they are small investors who are willing to build very small projects using much of their own labour, and value them below market value.
- If they opt for a higher initial equity investment than the 15% used here, which, due to lower financing costs, improves the return on investment.
- If they have different criteria/objectives related to measuring investment performance other than cash-on-cash-returns.

However, the analysis does illustrate that, in general, the economics of new rental unit development is still challenged, except in special circumstances.

FURTHER READING

Full Report – *The Economics of New Purpose-Built Rental Housing Development in Selected Canadian Markets (2016)* (ftp://ftp.cmhc-schl.gc.ca/chic-ccdh/Research_Reports-Rapports_de_recherche/2017/RR_Economics_of_New_Purpose_Sep18.pdf)

Project Manager:
Zabiullah Tarshi
Housing Needs
Canada Mortgage and Housing Corporation

Research Consultant: Altus Group

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ALTERNATIVE TEXT AND DATA FOR FIGURES

Figure 1: Average annual 10 year cash-on-cash returns, private rental

	With land costs			Without land costs		
	Lower range	Upper range	Average	Lower range	Upper range	Average
Vancouver	-10%	-3%	-8%	2%	11%	6%
Calgary	-10%	-7%	-8%	-5%	-2%	-4%
Winnipeg	-11%	-5%	-8%	-8%	-3%	-6%
Toronto	-7%	3%	-3%	-1%	11%	4%
Montréal	-5%	-1%	-4%	-3%	1%	-2%
Halifax	-11%	-6%	-9%	-8%	-1%	-5%

Figure 2: Economic rent premium over achievable market rent, private rental

	With land costs			Without land costs		
	Lower range	Upper range	Average	Lower range	Upper range	Average
Vancouver	33%	60%	51%	0%	20%	9%
Calgary	40%	57%	49%	20%	43%	31%
Winnipeg	29%	63%	47%	29%	50%	39%
Toronto	11%	33%	25%	0%	20%	12%
Montréal	14%	38%	28%	14%	33%	24%
Halifax	33%	75%	60%	17%	57%	41%