Economics

IN FOCUS

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GTA condo investment: Challenging times

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The Canadian economy is in a per-capita recession. Per-capita GDP has been continuously declining since mid-2022 and, at the current pace of decline it's approaching the pace of declines seen in the 2008 and 1991 recessions. In fact, it is fair to say that given the current environment, the Canadian housing market in general and the GTA market in particular are facing the most significant test since the 1991 recession.

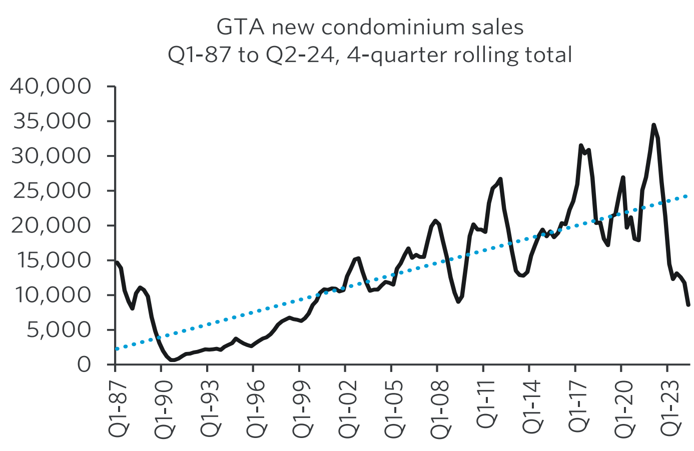
The GTA housing market is currently a tale of two markets. The low-rise market appears to be in reasonable shape with limited inventories and improved sentiment, given the recent trajectory of mortgage rates. That's not the case in the condo market, which is clearly in recessionary territory with conditions deteriorating to levels not seen in decades. What makes the situation more challenging is the role of investors in the presale market, which have made up to 70% or more of buyers.

Therefore, to understand where we are and where we are heading in the condo market, it is essential to get a clearer picture of the condo investment space at this moment of time. Combining datasets from Urbanation and Teranet, we can do exactly that. The following note updates previous studies we conducted on the topic, enabling us to get a sense of where we are now and relative to the past.

The GTA condo market is in a state of economic lockdown. The math doesn't make economic sense from both the demand side (investors) and the supply side (developers), leaving the market at a standstill. Prices are too high for investors to buy given current-resale prices, rents, and interest rates, while developers can't lower prices due to high construction costs. As a result, new condo sales — the primary driver of new home construction in Canada's largest market — have dove off a cliff to their lowest level since the late 1990s (Chart 1).

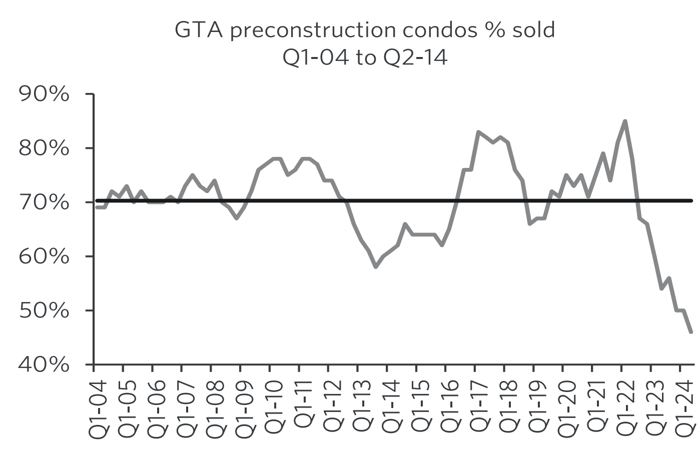
The percentage of pre-construction condos that are pre-sold is at a more than 20-year low of less than 50% (Chart 2). Without at least 70% presales, a project can't begin construction a fact that is working to dramatically slow down the supply pipeline. This reality will result in a sharp pull back in completions and a stagnating housing stock in the coming

Chart 1: GTA new condo sales plummet



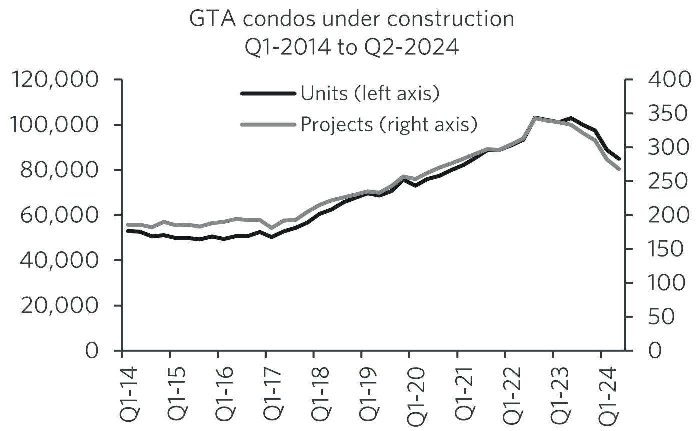
Source: Urbanation, CIBC

Chart 2: Projects can't qualify for construction loans



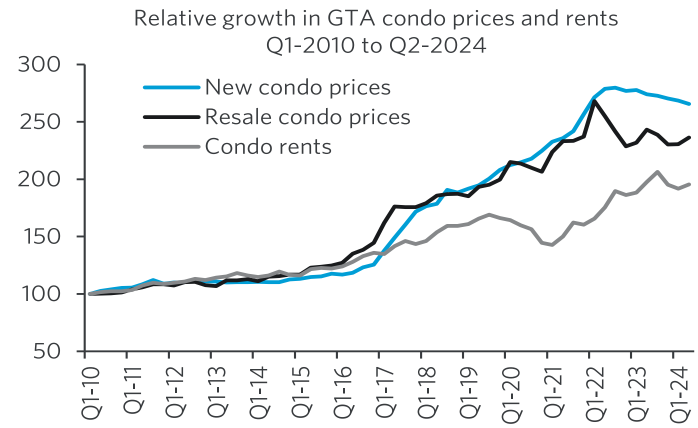
Source: Urbanation, CIBC

Chart 3: Condo construction is dropping fast



Source: Urbanation, CIBC

Chart 4: Downside stickiness for new condo prices



Source: Urbanation, CIBC

years, which is sure to make the affordability situation even worse.

From a macro perspective, the dramatic slowing in condo activity has important implications. As a simple rule of thumb, each construction crane represents about 500 jobs. Already, the number of condo projects under construction in the GTA has been reduced by no less than 75 since 2022 (Chart 3), impacting nearly 40,000 jobs. And the official statistics already reflect that. As of June of this year, overall construction employment in Ontario fell by no less than 7.5% on a year over year basis. With the exception of the COVID recession, this is the weakest showing since the 2008 recession.

Construction costs, which climbed rapidly in the past few years but are now hardly rising on an inflation adjusted basis, and in some pockets are in fact declining, will provide some relief for developers, but we do not see this trend lasting long. As for interest rates, at this point we see no reason to believe that the Bank of Canada will stop its easing campaign any time soon. We expect the Bank to take the overnight rate to around 2.75%-3% by the end of 2025, which will work along with reduced construction costs to help condo developers eventually bring prices closer in line with market demand.

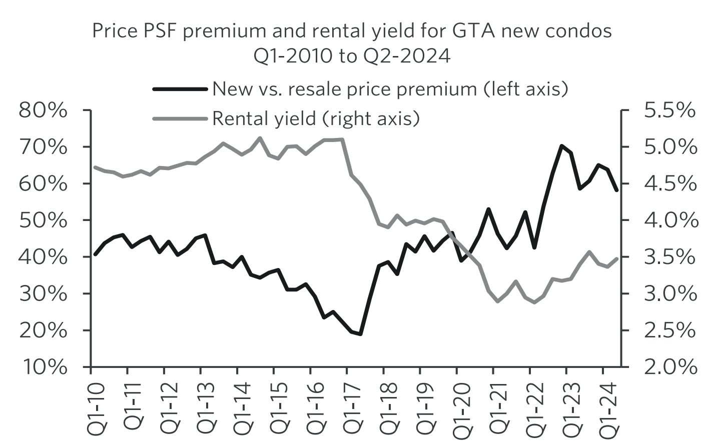
But another important factor to consider here is population growth. At the center of the efforts by the federal government to limit population growth is the newly introduced cap on international students and targeted decrease in the number of temporary residents to 5% of the population over the next three years. While we doubt that that policy will do much to reduce population growth in 2024 (See: Slowing population growth? Not so fast), it's reasonable to assume that population growth will be notably slower in 2025 and 2026. When combined with higher condo completions in the next two years, this will somewhat ease the pressure on the rental market, but it also potentially creates further headwinds for condo investment demand.

At least for now, we doubt that these forces will enable developers to lower prices to a level that will attract investors back into the market. Still elevated interest rates and ever-increasing municipal development charges mean new condo prices will remain sticky.

In fact, new condo prices have dipped by only 5% from their high, while resale condo prices have corrected by 12% and are at risk of further decline given the recent surge in listings (Chart 4). Buyer incentives offered by developers and rent growth of 30% from COVID lows have helped to bridge some of the gap for investors, but it's not enough. Quite simply, new condo investment doesn't work at the current market average price of close to $1,400 psf.

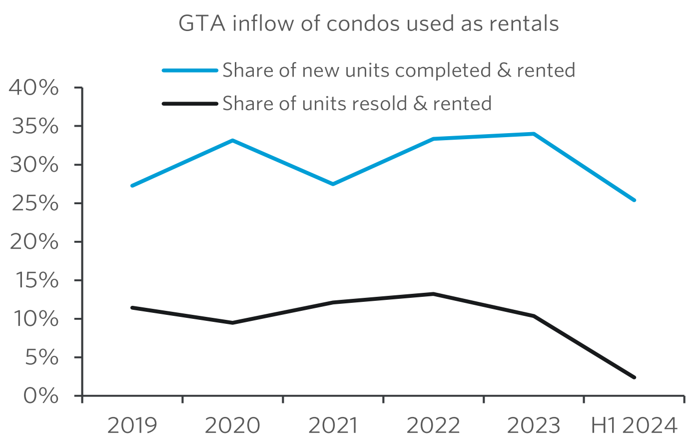
For condo investment to regain its appeal, we have to wait for resale prices and rents to rise faster, and interest rates to decline more significantly. The current price gap between new and resale condo prices remains near a record high at roughly 60%, and a full 20 percentage points above its long-run average. Meanwhile, rental yields are only slightly up from their record lows during COVID-19, and effectively below the risk-free rate offered by Government Bonds (Chart 5).

Chart 5: Condo investment loses its appeal



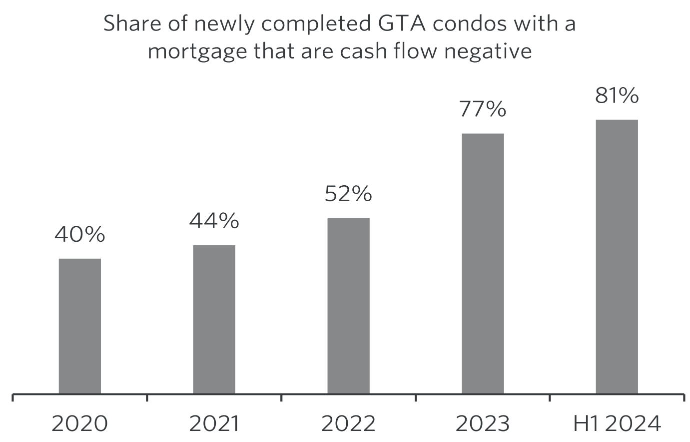
Source: Urbanation, CIBC

Chart 6: Condo rental supply is dropping



Source: Urbanation, CIBC

Chart 8: Large increase in cash flow negative condos



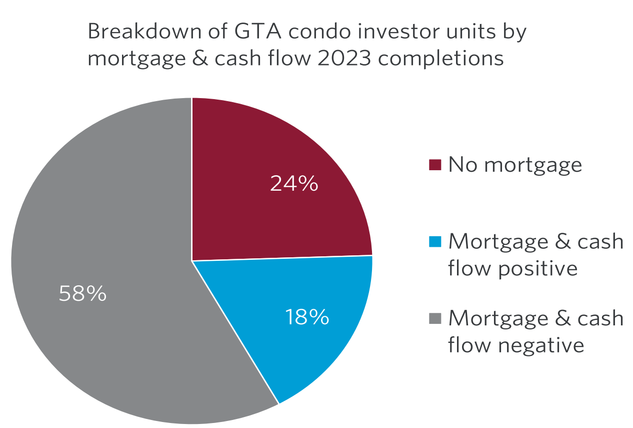
Source: Urbanation, Teranet, CIBC

Price appreciation, rental cash flow, and market confidence are the key ingredients for condo investment. The point of this analysis is not to make bold predictions about these factors, but rather to shine a brighter light on the current investment situation that condo investors are experiencing. Once again, we have partnered with Teranet to analyze how cash flow positions for rental investors are evolving.

Rental investment flows

Using the MLS as a basis, the share of newly completed condos used as rentals reached a recent high of 34% in 2023. However, the impact of higher mortgage rates began to change things in the first half of 2024 as the share dropped to 25%. We also saw a huge decline in investment activity within the resale market, where the share of units bought and then rented declined to a three-year low of 10% in 2023 before dropping to only 2% in the first half of this year (Chart 6). This was a predictable outcome given the challenges in buying and renting in the same market (investors of new condos typically buy pre-construction and wait for rents to rise over the course of construction).

Chart 7: Most condos are cash flow negative



Source: Urbanation, Teranet, CIBC

As the inflow of condo rental units remained concentrated in new projects, accounting for more than three-quarters of all condo rentals added last year and almost all condo rental units so far in 2024, let's dig deeper on the investment situation of these newly completed condo rentals.

Rental cash flow analysis

Nearly one quarter of all newly completed condos in 2023 that were used as rentals did not have a mortgage. This share was consistent with data from previous years.

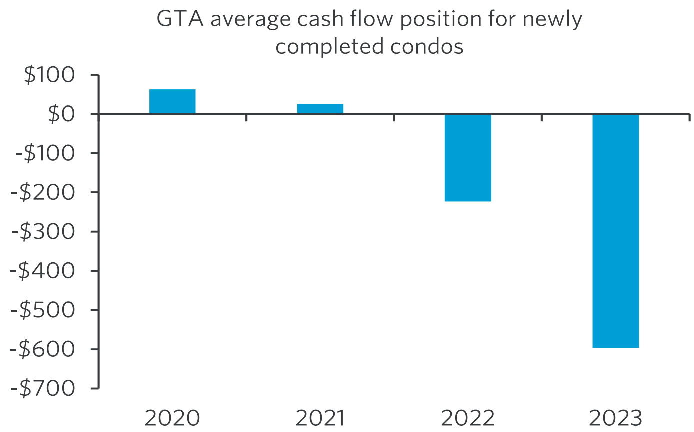
Using the entire pool of condo rentals completed last year, 58% had a mortgage and were cash flow negative (i.e. rents did not cover ownership costs including mortgage, condo fees and property taxes). Only 18% had a mortgage and were cash flow positive (Chart 7).

Focusing solely on leveraged investors for this analysis, we see that 77% were cash flow negative in 2023, representing a large increase from 2022, which marked the first time that the majority of investment units turned cash flow negative with a 52% share. First half results for 2024 show the situation worsening still, with 82% of leveraged investors in a cash flow negative position (Chart 8).

Our analysis of the data found that, on average, condo investors that closed on their newly completed units in 2023 experienced negative cash flow to the tune of $597 per month, which was more than 2.5 times greater than the negative cash flow that investors that closed in 2022 experienced (-$223) and a far cry from the days of positive cash flow in 2020-2021 (Chart 9).

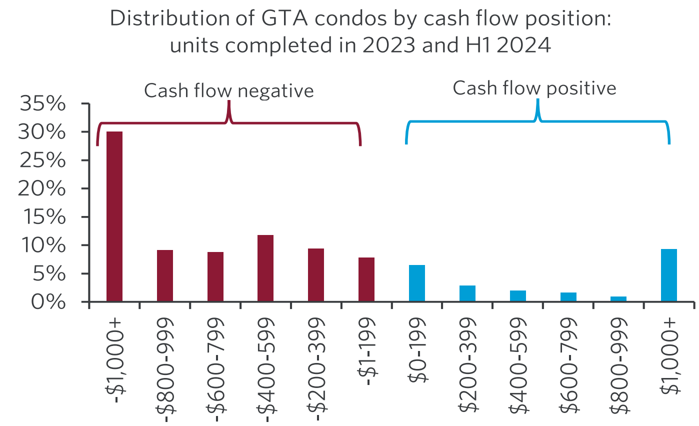
While rents achieved on leases of newly completed condos rose 8% last year to a record high average of nearly $2,700, average monthly ownership costs rose 21% to reach nearly $3,250 per month. This was due to a combination of higher priced units reaching completion in a higher interest rate environment. Since

Chart 9: Negative cash flow positions worsen



Source: Urbanation, Teranet, CIBC

Chart 11: 30% are cash flow negative by $1,000+



Source: Urbanation, Teranet, CIBC

2020, ownership costs have soared by nearly 60%, more than doubling the increase in rents over the same period (Chart 10).

When examining the distribution of cash flow by dollar amount, the results showed that 30% of investors of new condos completed in 2023 were cash flow negative by $1,000 per month or more in 2023 (Chart 11). This was more than double the 14% share in 2022.

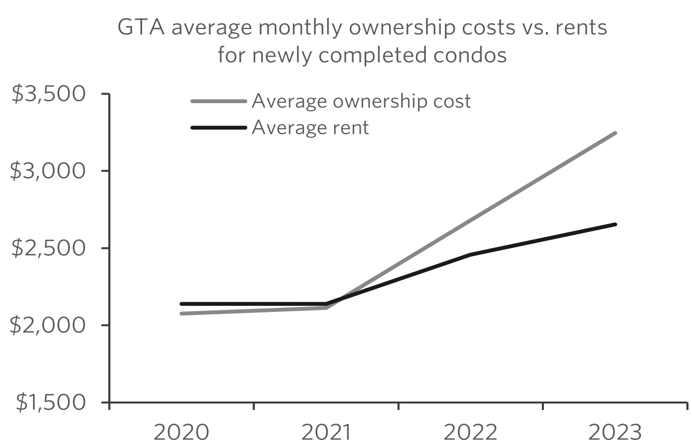
If it wasn't for the increased share of mortgages provided by the big 5 banks, rental cash flow likely would have been even worse. The big 5 banks held nearly three-quarters of all investor mortgages that closed in 2023, up from a 55% share in 2022. The big 5 generally offer better rates and financing terms for investors compared to other lenders, which range from credit unions, trust companies, mortgage loan and investment companies, and private individuals. Negative cash flow positions on loans provided by the big 5 banks averaged $359 for newly completed units in 2023, versus negative cash flow of $918 on loans provided by other types of lenders (Chart 12).

The bigger the unit, the larger the negative cash flow position. Studio units were effectively cash flow neutral on average for condos completed in 2023, compared to negative cash flow averaging $523 for one-bedroom units, $734 for two-bedroom units, and $866 for three-bedroom units (Chart 13). This provides some insight as to why investors favour smaller units, and the scarcity of rental options in the market for larger units. Only 3% of condos completed in 2023 that were held as rental investments were three-bedroom units.

Wrapping up

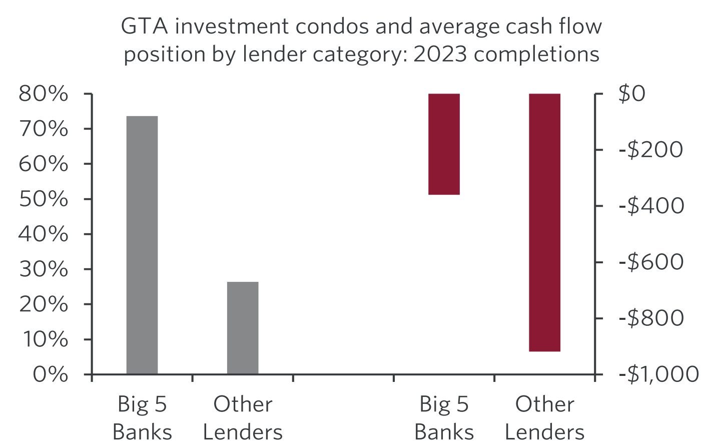
In a market that still builds relatively few purpose-built rentals, condo investors remain critically important for growing rental supply and contributing to the improvement in overall housing affordibility and growth in the GTA economy. However, investors have scaled back dramatically on buying new units and those who previously bought presale units reaching completion and are reaching the stage are finding themselves in increasingly more precarious investment situations by the

Chart 10: Ownership costs rise 3x faster than rents



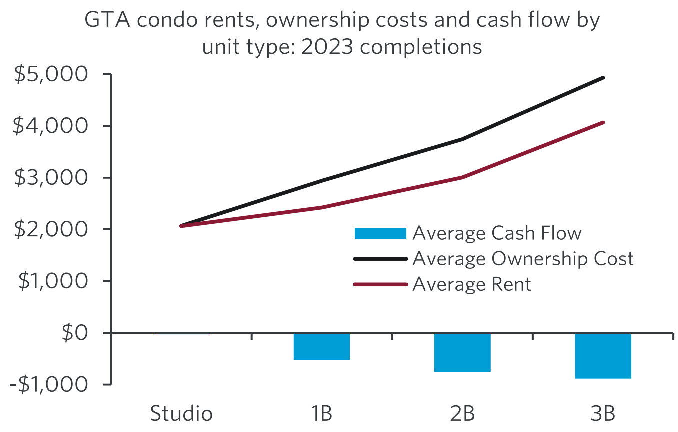
Source: Urbanation, CIBC

Chart 12: Big 5 share of investor loans at nearly 75%



Source: Urbanation, Teranet, CIBC

Chart 13: Studios perform best for cash flows

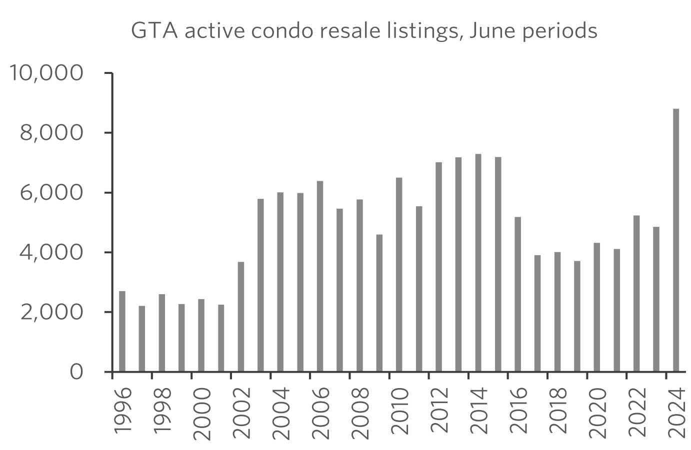


Source: Urbanation, Teranet, CIBC

day. Indeed, condo completions are rising sharply in the near-term as the past boom in presales makes its way through the development process. This means increased competition to sell and lease amongst investors.

The more difficult economic environment for condo investors appears to be causing a recent shift in behavior, where many more are putting their units for sale. This can be seen through the record high number of condos listings currently on the market (Chart 14), which can be correlated to the approximately 60% share of the stock built in recent years that is owned by investors. This is a troubling sign for the outlook for rental supply in the region and raises an alarm bell over the necessity to increase purpose-built rental supply.

Chart 14: Record number of condo resale listings



Source: Urbanation, CIBC

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