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GTA Condo Investment – The Landscape

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As we get closer to the end of the crisis, the narrative in the GTA housing market is starting to change. The specific nature of the crisis led to a situation in which the low-rise segment of the market outperformed notably. But in recent months, the condo space has seen renewed strength. With the price of detached units approaching resistance levels, condos are being viewed as the only affordable channel, with investors playing a big part in that renewal story.

To gain a better understanding of this key market, CIBC and Urbanation Inc have combined efforts to provide a close look at condo investors in the GTA through the lens of quantitative research, using thousands of recent transactions as an input.

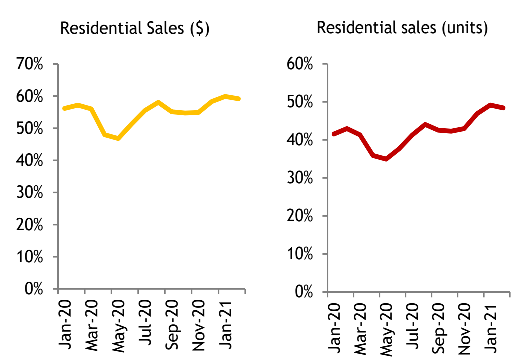
Toronto Is Still the Center of the Universe

A lot has been said about the great exodus from Toronto during Covid, as the ability to work from home led to a wave of Toronto refugees seeking shelter in more affordable, smaller centers. That trend started before the crisis and accelerated over the past year. However, a quick glance at Chart 1 puts that narrative into perspective.

The GTA's share in resale activity in Ontario was little changed over the past year, accounting for 50% and 60% of unit sales and value sales, respectively. Zooming in on the neighbouring areas of the GTA reveals the same picture. The share of sales in centres that are between 50km and 300km from the GTA still represents less than 5% of sales (Chart 2).

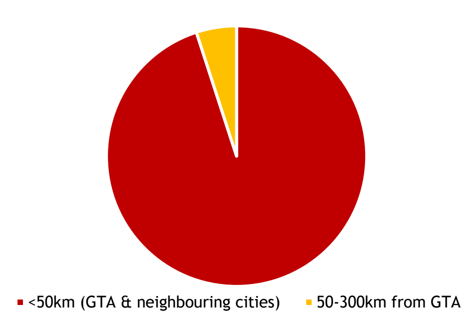
What's more, the highly quoted data released recently by Statistics Canada that showed that more than 50K Torontonians left the city during the year ending July 2020, doesn't tell the whole story. That outflow was more than offset by the undercounting of returning citizens and

Chart 1
Share of GTA in Ontario Home Sales



Source: CREA, CIBC

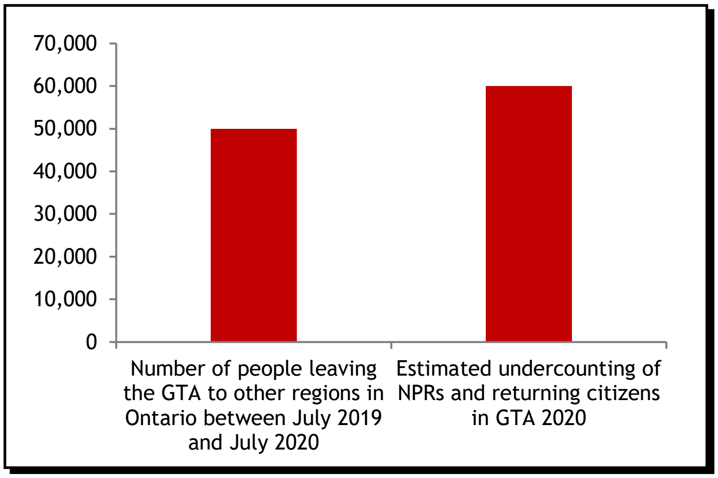
Chart 2
Share of Home Sales Within 300km of GTA



Source: CREA, www.distance.to, CIBC

Chart 3

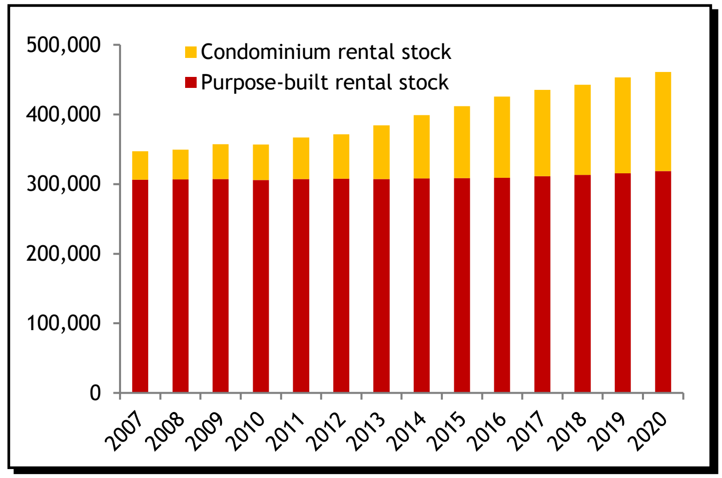
GTA's Demographics—Better than Headline Figures Suggest



Source: Statistics Canada, CIBC

Chart 4

Rental Apartment Universe Toronto CMA



Source: CMHC, Urbanation, CIBC

non-permanent residents in the GTA, which implies a much better demographic picture than suggested by the headline numbers (Chart 3).

All of the above is to illustrate that demand in the GTA remains strong. Accordingly, we take a closer look at the condo market by zooming in on the important investors' space.

Condo Investment: A Closer Look

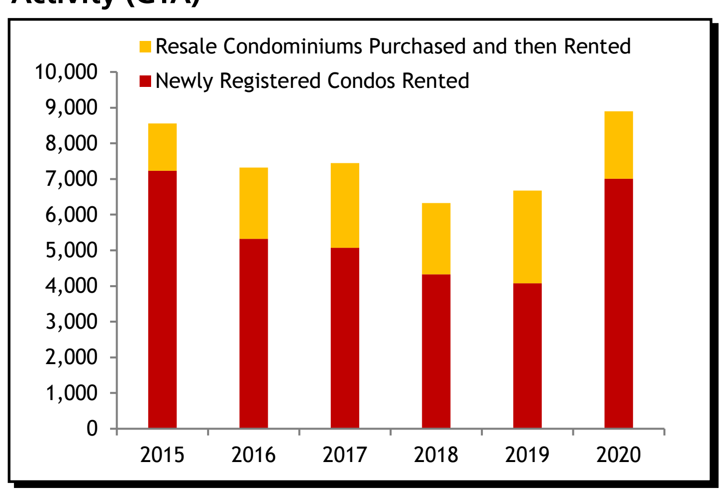
If you want to understand the rental market in the GTA, you must understand the current status of condo investors. While purpose-built rental development has been rising in recent years from depressed levels, condominiums have represented just under 90% of the net gain in rental apartment units in the GTA over the last decade according to CMHC data. Indeed, one out of every three condos across the region is owned by a rental investor (Chart 4).

Last year, investors closed on a record of nearly 9,000 condo rentals in the GTA, a figure that doesn't include owner-occupiers converting their units to rental. Roughly one-third of all newly registered condos bought by pre-sale purchasers were rented last year through MLS, in addition to approximately 10% of resale purchasers who bought units as rental investments (Chart 5). With the bulk of condo rental supply growth coming from new developments, it's important to examine the economics of buying presale and holding at completion. Urbanation and CIBC completed an exercise three years ago that looked at that issue based on 2017 data — with so much change in the market and the world since then, it's time to re-examine the data.

Zooming in on the price trajectory of those investments, we learn that capital appreciation has remained strong but rental yields have fallen. In the three-year period ending in Q4-2020, new condominium prices in the GTA were up 27%, resale prices were up 18%, and rents were essentially flat after suffering a 13% decline in 2020 due to the pandemic. We also know that many presale units that closed last year were presold more than three years ago and prior to the sharp rise in new condominium prices experienced in 2017. Having locked-in prices that

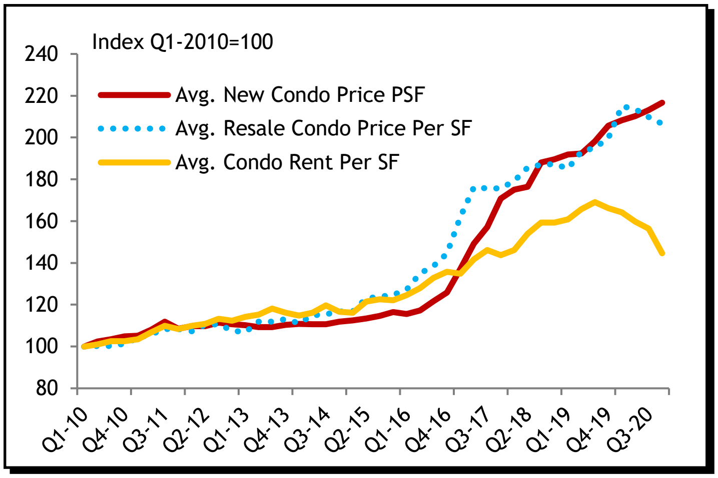
Chart 5

Total Annual Condominium Rental Investment Activity (GTA)



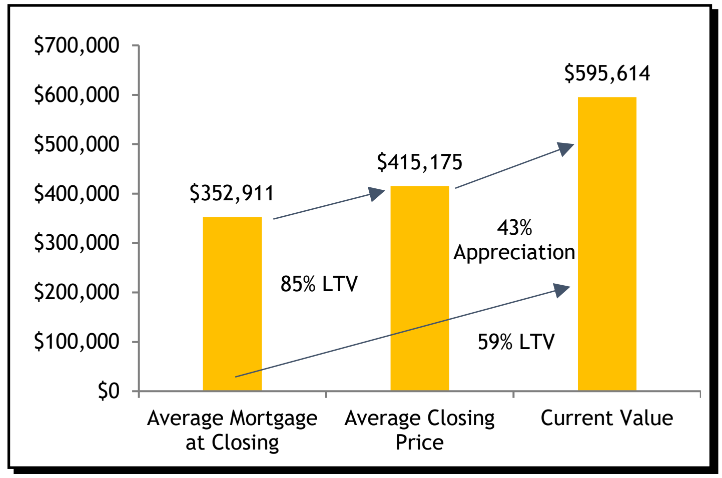
Source: Urbanation

Chart 6
Condo Prices and Rents (GTA)



Source: Urbanation

Chart 7
Newly Registered Condo Investment Units (GTA, 2020)



Source: Teranet, Urbanation, CIBC

are heavily discounted compared to current market prices has created substantial equity accumulation for investors while record low borrowing costs helped to improve their cash flow situation despite the drop in rents (Chart 6).

Digging Deeper

But to get a better understanding of that space, we have to examine the economics behind those transactions. Using sales and rent information for condo transactions that were completed and registered in 2020, and used as rentals, obtained from Urbanation Inc, and aligning it with the matching purchase price and mortgage information obtained from Teranet, we are able to shed some light on that segment of the market. The goal here is not to make bold predictions, but rather to provide hard data on rental condo investors that is currently missing from the marketplace.

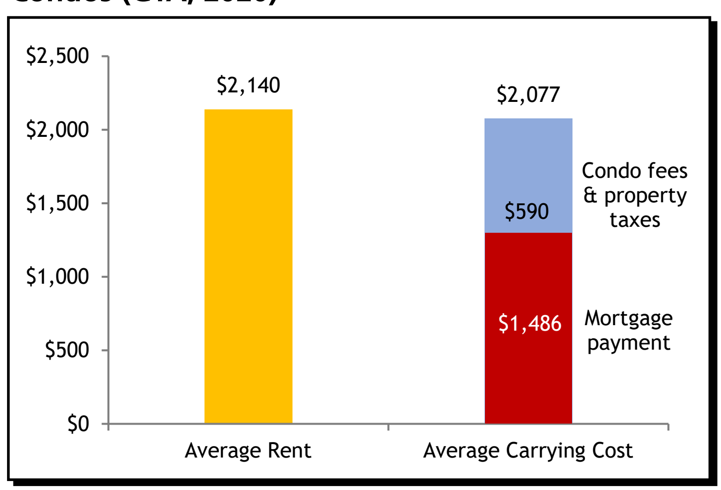
The data reveal that the average unit was pre-sold for $415,175 with an 85% loan-to-value at closing (typically developers and lenders require a minimum 20% down payment but some purchasers refinance to a higher LTV at closing). Based on resale market values examined in these buildings, it was found that the average unit was worth approximately $595,614, more than 40% higher than the average pre-sale price (Chart 7). This resulted in an effective current market LTV of 59%, which doesn't include outstanding credit linked to the purchase that wasn't registered on title.

Cash Flow

Using payment data on all registered mortgage loans on rental units and adding in condo fees and property taxes, the average unit had an ownership carrying cost of $2,077 per month. For these same units, the average achieved rent after completion was $2,140, leaving a small amount of positive cashflow (Chart 8).

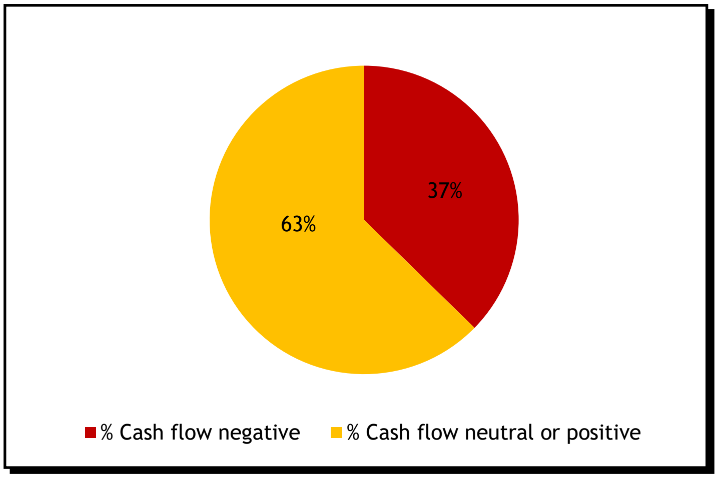
At 63%, the share of investors that were cash flow neutral or positive in 2020 was higher than the 56% share calculated for 2017 newly registered investment units (Chart 9). While HELOCs and other credit vehicles used for funding that were not registered on title would surely

Chart 8
Rents versus Carrying Costs for Newly Completed Condos (GTA, 2020)



Source: Teranet, Urbanation, CIBC

Chart 9
Condo Rental Units Registered in 2020 by Cash Flow Position (GTA)



Source: Teranet, Urbanation, CIBC

reduce the percentage of cash flow positive investors, it is also true that a large number of investors closed on their units with no mortgage at all. Furthermore, with interest rates as low as they are, roughly half of mortgage payments in the first year go towards principal with a stretched out 30-year amortization. And principal repayment only gets better each year. The average age of a condo investor closing on their new unit last year was 47, an age in which planning for retirement comes into focus.

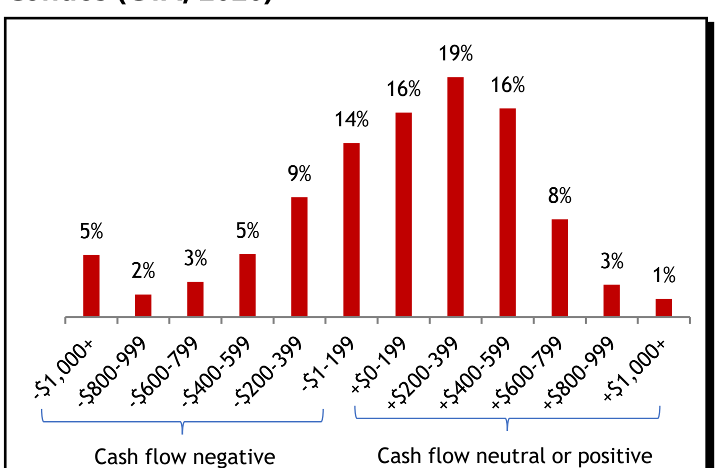
Investors of presale units were in a much better cash flow position than investors that bought resale units and subsequently rented them out last year, finding that a majority share (80%) of these resale investors were cash flow negative.

The cash flow distribution is presented in Chart 10 and reveals that a strong majority of condo investors weren't accepting large amounts of negative cash flow. In fact, more than half of all condo investors were cash flow positive by up to $600 per month and less than 15% were cash flow negative by more than $400 per month. Those that were cash flow negative by $1,000 or more per month represented just 5% of investors.

Peeling back the layers of the data reveals a large difference in leverage between cash flow negative and cash flow positive investors (Chart 11). Cash flow positive investors had an 80% LTV based on closing prices while cash flow negative investors in many cases refinanced to today's values, raising their LTV to 95% of closing prices (not current resale values). Among investors with positive cash flow, average monthly net income was nearly $400, which was higher than in 2017 when positive cash flow investors averaged just over $360. For the cash flow negative investors, the approximately $5,900 annual net loss (not factoring in principal repayment) in year 1 can be offset by just a 1% increase in market prices.

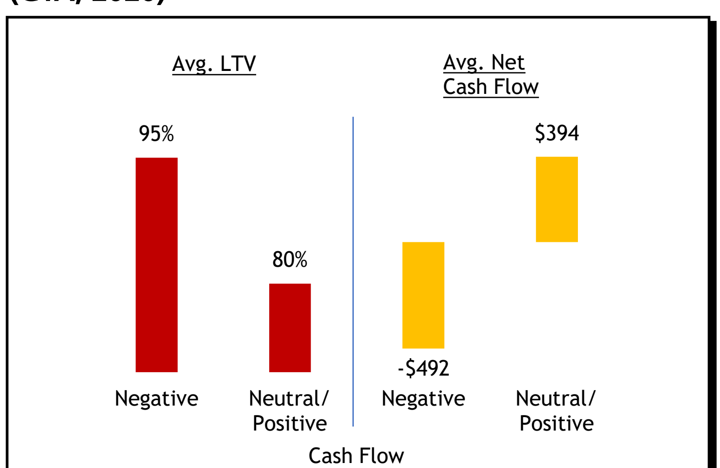
Looking at the supply of credit, we find that investors with mortgages with the Big 5 banks average positive cash flow of $186 per month, and investors financed through other banks essentially are cash flow neutral. Credit unions, trust companies, insurance companies and monolines lent to investors that were slightly negative in cash flow, with investors that obtained financing privately had by far the largest negative cash flow. Compared to

Chart 10
Cash Flow Distribution of Newly Registered Condos (GTA, 2020)



Source: Teranet, Urbanation, CIBC

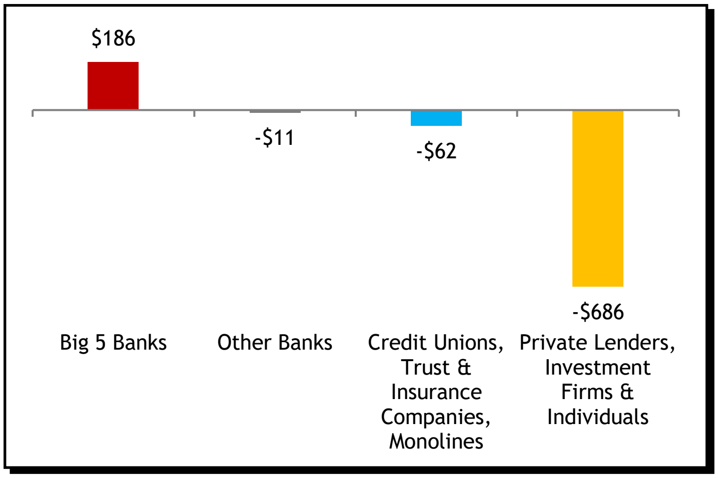
Chart 11
Loan-to-Value and Net Cash Flow for New Condos (GTA, 2020)



Source: Teranet, Urbanation, CIBC

Chart 12

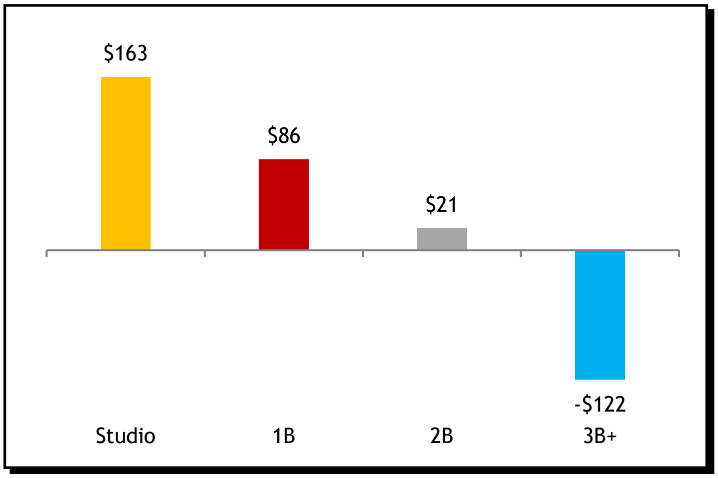
Average Monthly Cash Flow for Newly Registered Condos (GTA)



Source: Teranet, Urbanation, CIBC

Chart 14

Average Monthly Cash Flow for Newly Registered Condos (GTA)



Source: Teranet, Urbanation, CIBC

the study based on 2017 data, the Big 5 market share of condo investors declined from 75% to 70% and the private market share declined from 10% to 8%, leaving higher market share for some other financial institutions that are not federally regulated and don't have to apply the mortgage stress test, including credit unions (Charts 12 & 13).

In terms of unit type, there was a clear negative correlation between the size of the unit and the amount of cash flow, with studios performing best but still only representing 6% of the market. Only three-bedroom units had average negative cash flow, although these larger units comprised only 2% of rental investments. (Charts 14 & 15).

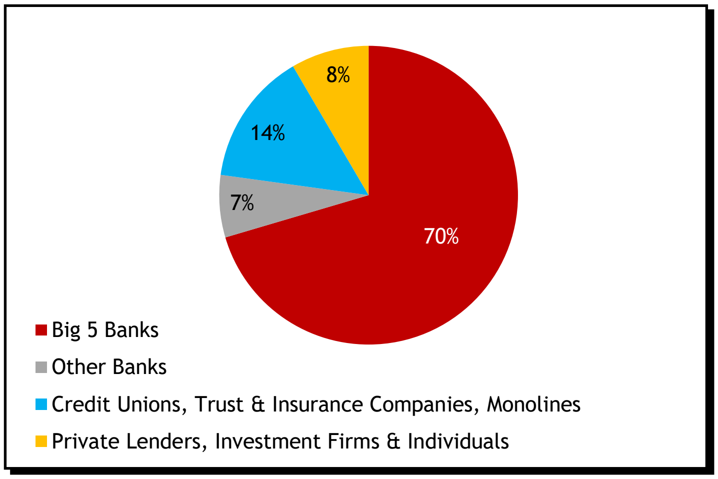
So there you go, all you wanted to know about condo investors, but were afraid to ask. So what does all of this mean for investors and the market going forward?

We know that the divergent paths for condo prices and rents recently will mean that the share of cash flow negative investors will likely rise in the future, unless they are prepared to invest a much higher down payment through savings.

We also believe that the current state of the rental market represents a blip in comparison to its long-term trajectory. And we suggest that cash flow isn't the main motivating factor for condo investors, it's capital appreciation. While

Chart 13

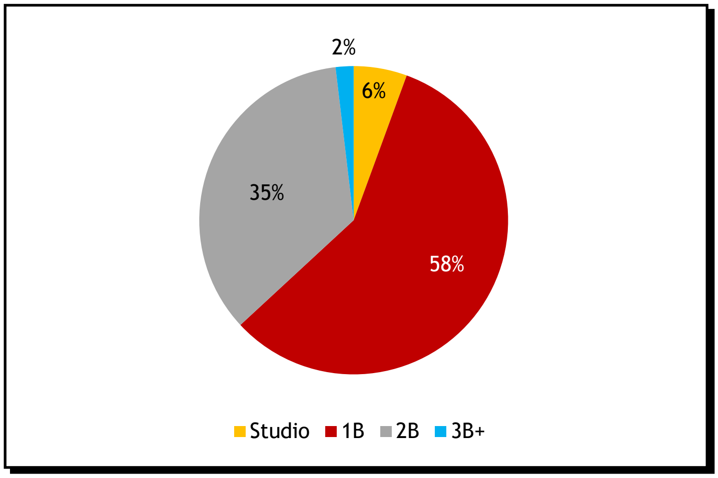
Newly Registered Condo Rentals by Lender (GTA)



Source: Teranet, Urbanation, CIBC

Chart 15

Newly Registered Condo Rentals by Unit Type (GTA)



Source: Teranet, Urbanation, CIBC

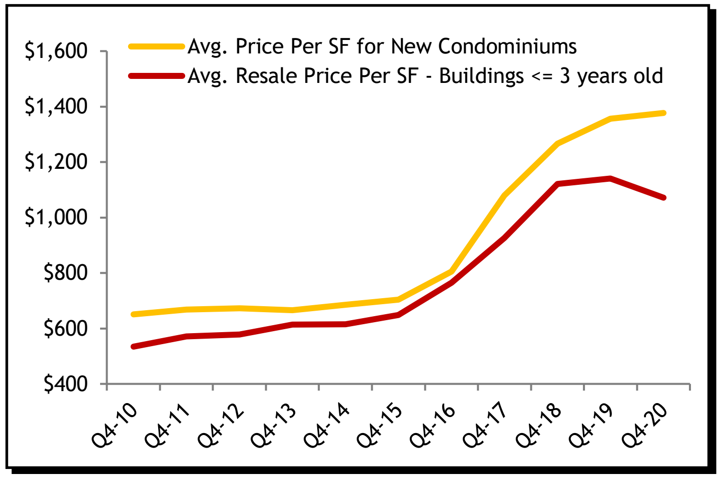
pre-construction prices are elevated relative to resale values last year (Chart 16), that gap has started to narrow in recent months due to a reacceleration in resale condo prices that has occurred this year (not captured in the chart).

Bottom line: Condo investment is still alive but it's a long-term strategy.

Condo investors are an integral component of the rental supply equation in the GTA, but the condo market shouldn't be the rental market. We believe that relying mainly on this form of supply is suboptimal due to reasons we will discuss in a future publication. Purpose-built rental housing development must be part of the solution. It is beginning to expand, but we are a long way off from closing the supply gap.

Chart 16

New Versus Resale Condominium Prices (Former City of Toronto)



Source: Urbanation