



TD Economics

Topic Paper

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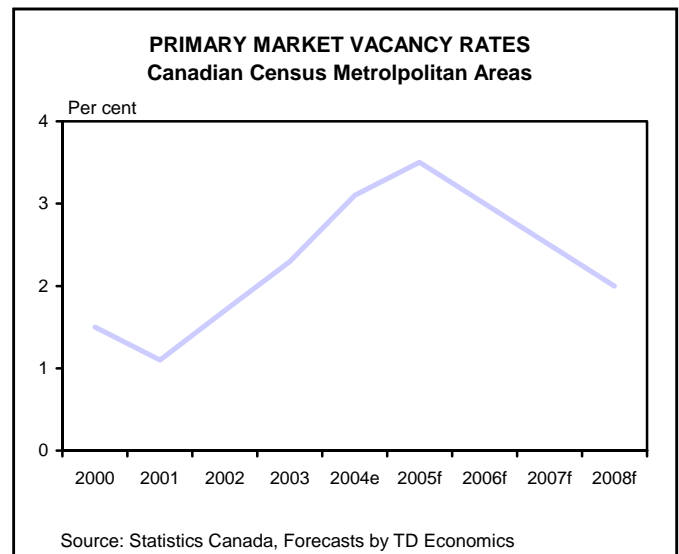
ROOM FOR RENT

Outlook For Canada's Rental Housing Market

In 2003, rental apartment vacancy rates jumped through the roof, putting a swift end to the rapid rent increases seen in the 1980s and 1990s. The irresistible lure of homeownership under historically low interest rates appears to have been the catalyst in this turn of events, further aided by a pick-up in supply of rental units after more than a decade-long drought. In particular, a booming condominium market not only provided a relatively cheap source of ownership for would-be renters, but it also generated a flood of new rental supply that has siphoned demand away from the traditional apartment units, especially in the high end of the rent range.

Although rising interest rates will erode home affordability and help to stabilize renter demand for apartments, we do not expect a full-fledge recovery to take place until 2006. In fact, we believe vacancy in some of Canada's largest rental markets will hit new highs in 2005.

Once investors leap over the near-term supply hurdle, the next challenge will be to adapt to the changing face of the rental market. The demographic trend has already turned against the rental market with young adults – a primary feeder to rental markets – representing a smaller share of the population, while also showing a greater tendency to live at home longer with their parents. Meanwhile, a greater proportion of the population is moving into higher wealth years, which is typically associated with homeownership. In order to fill the gap, rental investors will become increasingly dependent on immigrants, who require more “affordable” housing options.



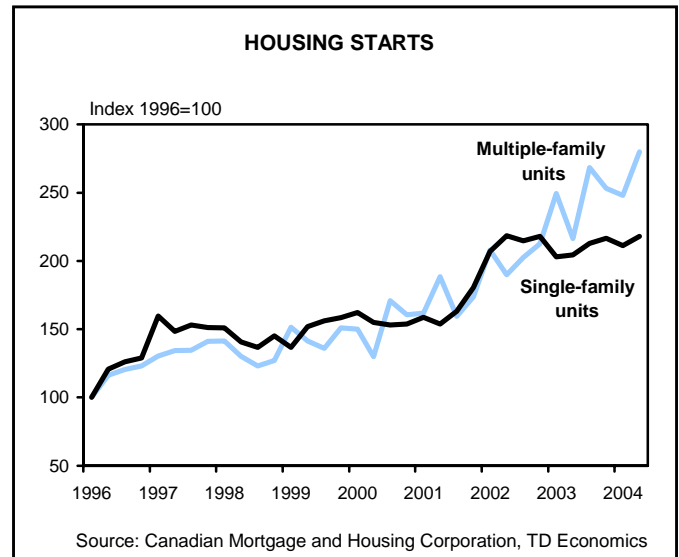
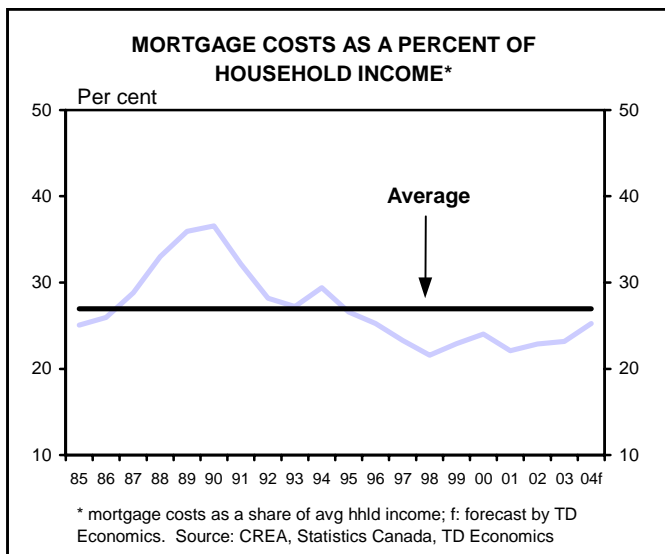
The decline and fall of rental properties

In 2002, the economy expanded at a brisk pace, the labour market had one of the best years ever with more than half a million new jobs, and after-tax incomes rose at a healthy 4-per-cent clip. Yet, rental investors didn't benefit from any of this good fortune, as nationwide vacancy rates moved higher and have not looked back since. This is the mirror opposite of the late 1990s experience, in which a booming economy supported increased rental demand, slicing vacancy rates by more than half.

There are a number of factors that explain the divergence between the late 1990s and today, but the main one lies in the current favourable interest rate environment for homeownership. Between 1991 and 1997, nationwide

vacancy rates held above 4 per cent (nearly twice the long-term average) alongside sluggish labour market conditions that kept a cap on rental demand throughout this period. As the job market finally emerged from its extended hiatus, more individuals could afford to move into the rental market. Since interest rates were trending down, undoubtedly some renters were enticed into the buyers market. But, the level of mortgage rates would still have been a restrictive factor for many renters, since rates were only returning to their historical norms from elevated levels. Meanwhile, a complete absence of new rental construction initiatives for more than a decade alongside this pick-up in demand made for exceedingly tight rental conditions.

This time around, interest rates were lowered to multi-decade lows, allowing bargain-basement mortgage rates to cast a much wider net on new buyers. For instance, the average 5-year conventional mortgage rate dropped a full percentage point between 2000 and 2001 to 7.4 per cent, and was further reduced to 6.4 per cent in 2003 – a level not seen since 1956. For the average would-be renter, this meant that monthly mortgage carrying costs on a \$155,000 principal (i.e. 75 per cent of national median home sales price in 2003) paid over 25 years was reduced by \$194. Conversely, the monthly mortgage payment would amount to \$1029, which was roughly equivalent to what a 2-bedroom unit rented for in major urban centers like Toronto, Vancouver and Ottawa. Granted, homeowners still have the added costs of property taxes, maintenance and utilities, but the economics of ownership hadn't looked this good in decades.



Condo demand heats up

To make matters more difficult, renters were finding enticing opportunities in the secondary market (i.e. owner-occupied units that are rented out and compete with apartment units in the “primary market”). Residential construction has been booming since 2000 with a keen focus on condominiums – so much so, that condo construction outpaced that of single family homes for the first time since the late 1980s. The increase in condominium supply not only offers a less expensive ownership alternative than single unit homes for would-be and existing renters in the mid-to-high rental range, but it also increases rental supply in the secondary market through investor ownership of condo units. Interestingly, of the two impacts, a Toronto study by CMHC found that owner occupied condos had a more dampening impact on the rental market with buyers vacating their existing rental suites. Nevertheless, the popularity of condo rentals is clear. Vacancy rates in the primary rental market are estimated to have risen to a lofty 4-to-5 per cent in Toronto this year, but those for condos in the secondary market have been nearly cut in half since last year to 0.9 per cent.

Primary market supply making a comeback

Low interest rates also improved the economics of investment. Spurred on by tightening rental markets in the late-1990s, rising rents, and low borrowing costs, investors began to consider new construction initiatives. Granted, in comparison to the 1980s, the current level of new rental supply cannot be characterized as robust, but it nonethe-

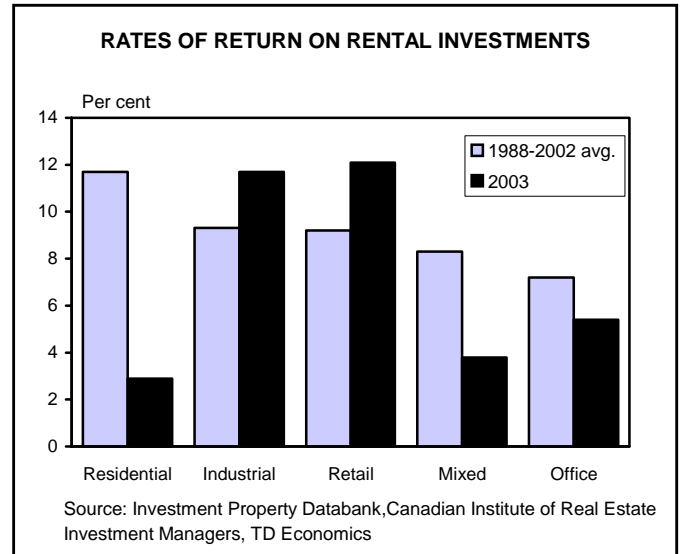
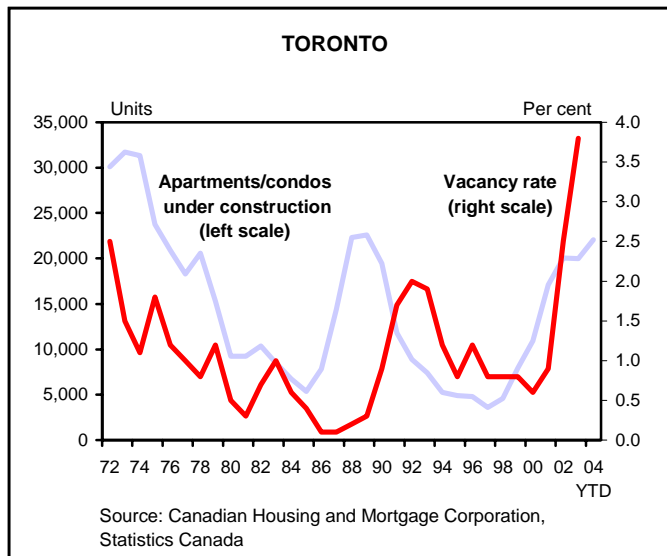
less added to the availability of units during a time when demand was dropping off.

The end result was the fruition of basic economic theory. An increase in supply combined with a decrease in demand make for slack rental markets. Apartment vacancy rates have risen in most urban centers, rental rates have flattened out, and, not surprisingly, returns on rental investment have dropped off significantly.

Location, location, location

Nationwide vacancy rates doubled last year from a low of 1.1 per cent in 2001, with some cities experiencing more pain than others. For instance, vacancy rates in Vancouver rose to 2 per cent, which was about twice its long-term average. Meanwhile, rental vacancy rates in Toronto's primary market hit 3.8 per cent in 2003, which was the highest on a record that dates back to 1971. This market suffered a particularly large fallout alongside a booming condominium market that saw new construction initiatives reach a 12-year high in 2000. Many of these units were completed in 2002 and 2003, which, in turn, caused a massive outflow of renters as they took possession of their new homes. Although most major urban markets reflected a similar experience, it was to a lesser extent. Montreal was the exception here, where vacancy rates remain tight and where new construction remains historically low and dominated by retirement homes.

Toronto was also the victim of some old-fashioned bad luck, of sorts. Immigration flows into Canada in 2003 plummeted by an unprecedented 57,000 from the previous year



that had more than 250,000 new immigrants enter the country. This has important implications for the rental market because three-quarters of new immigrants initially rent their accommodations. More importantly, the bulk of new immigrants settle in Toronto (46%), with Vancouver (15%) and Montreal (13%) placing a distant second and third.

Investors feel the pain

While Toronto is but one example, residential rental investors across Canada felt the swift blow of rising vacancy. Rental investments returned a meager 2.9 per cent in 2003, a far cry from the average 12 per cent return realized over the prior 15 years. To add insult to injury, although residential rental investments traditionally outperform other real estate asset classes (retail, office, industrial and mixed), none of these showed any comparable sign of strain. In fact, retail investors benefited from one of the best performances in thirteen years, while the double-digit yield on industrial assets was consistent with past experiences. For that matter, risk-free 10-year Government of Canada bonds would have made a shrewd investment with an average yield of 4.8 per cent over the year.

No recovery until 2006

Some of the issues currently restraining the rental market will self-correct in the next two years, providing some relief to investors. Mainly, as interest rates gravitate towards a more neutral level of 3.5 to 4 per cent over the next twelve months, the cost advantage of owning versus renting will fade. At the same time, the deterioration in

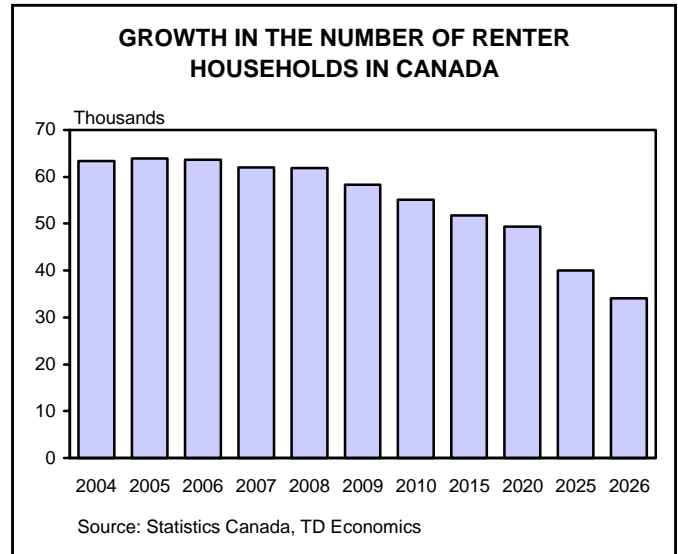
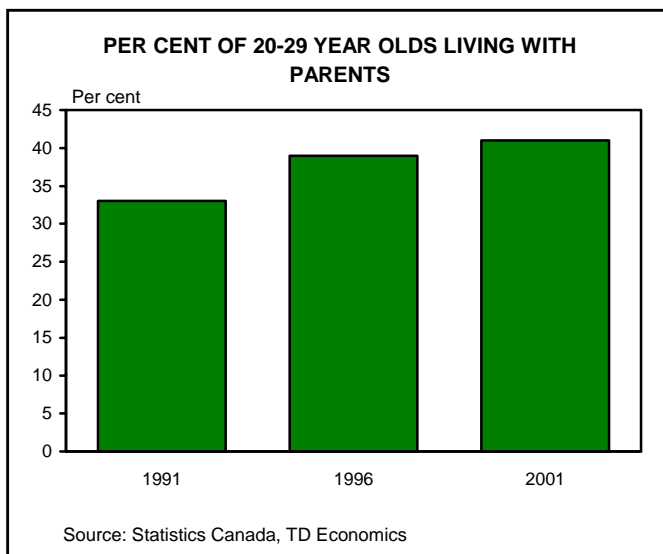
affordability will squeeze some potential buyers out of the market and swing the momentum back towards the rental market. However, since interest rates will still be at moderate levels relative to history and inflation, we don't believe the shift back to renting will be dramatic enough to allow for a full-fledged recovery until 2006. At that time, some of the heightened competition from the secondary market (i.e. condo) will have also eased.

But until then, the full impact from increased competition in the condominium market has yet to play out. The data for the first eight months of this year show that condominium construction is at a cyclical high, with the Toronto and Vancouver markets representing the lion's share of activity. This influx of units will eventually come on line and further drain demand from the primary rental market. And, newly constructed condominiums offer an appeal that cannot be matched in the aging stock of the primary apartment rental market, especially with the bulk of these constructed during the 1960s and 1970s.

There may also be a smaller second round effect on the primary rental market waiting in the wings. The lower cost of condominium ownership tends to appeal to younger ages, but it also tends to be a first, and not last, step in homeownership. Eventually, many of these individuals will move into single unit homes to accommodate families, at which point some of these units may be retained as a rental investment opportunity.

Longer term challenges

Once rental investors leap over this near-term supply

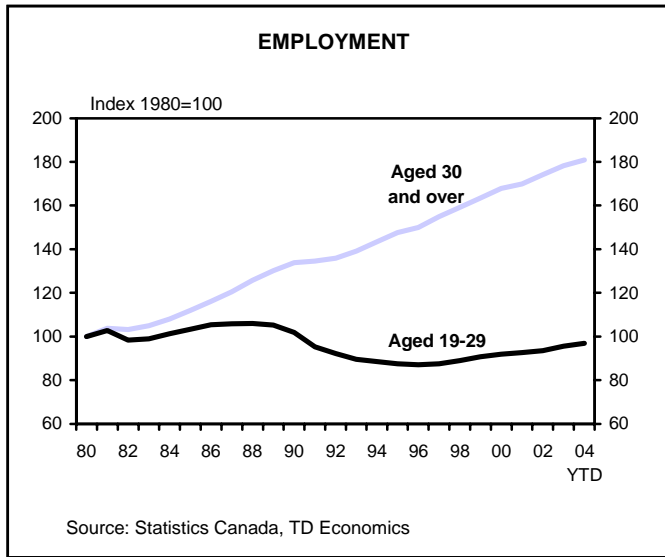


hurdle, the next challenge (and opportunity) will be to adapt to the changing face of the rental market. A dramatic demographic shift is underway, and investors cannot ignore the importance of immigrants in the rental demand equation. By our estimates, growth in the number of renter households formed between now and 2026 will be cut in half, with immigrants encompassing the primary source of this demand.

Children not cutting the cord

Before the year 2026 is upon us, the rental market will experience a much-diminished feeder market. The number of individuals aged 15-to-19 will decline by nearly a quarter million by 2020, and the 20-to-29 age cohort will decline by an estimated 364,000 individuals between 2020 and 2026. And, the impact of an outright decline in the population of young adults will be compounded if the recent sociological phenomenon of children living at home longer with their parents turns out to be more than a passing fad.

In the second half of the 1990s, apartment rental investors faced diminished demand from young adults. Indeed, past tightness in rental markets combined with the pursuit of higher education and increasing student debt loads may have been catalysts in keeping children at home longer. What's more, those who did seek independence from their parents' household would have had a hard time finding a job to support rising rental rates. Even though the job market was flourishing in Canada, those below the age of 30 did not benefit from increased employer interest. In fact, the number of young adults employed is currently little dif-



ferent from that in 1980.

The end result – many young adults are bypassing the renting stage all together. CMHC noted that between 1996 and 2001, growth in the number of households who owned their homes accelerated while that of renter households scarcely increased. As a result, homeownership rates in Canada rose to 65.8 per cent from 63.6 per cent, marking the largest gain for any five-year period dating back to 1971. Part of this is attributed to the maturation of the baby boomers who are moving into high-wealth years that are typically associated with residence ownership. However, that does not explain why ownership rates rose across all age groups and were especially pronounced for those below the age of 30. Indeed, it was estimated that the aging population accounted for less than half of the change in ownership rates, with estimates varying widely between cities. For instance, CMHC found that aging accounted for less than one-fifth of the increase in ownership in Calgary and about one-quarter in Toronto. Although this phenomenon of young adults living with their parents might ease under the current situation of falling rent rates, high vacancy and rising interest rates, there is a risk that a broader trend is at work that could permanently lower the proportion of young adults who seek rental accommodations.

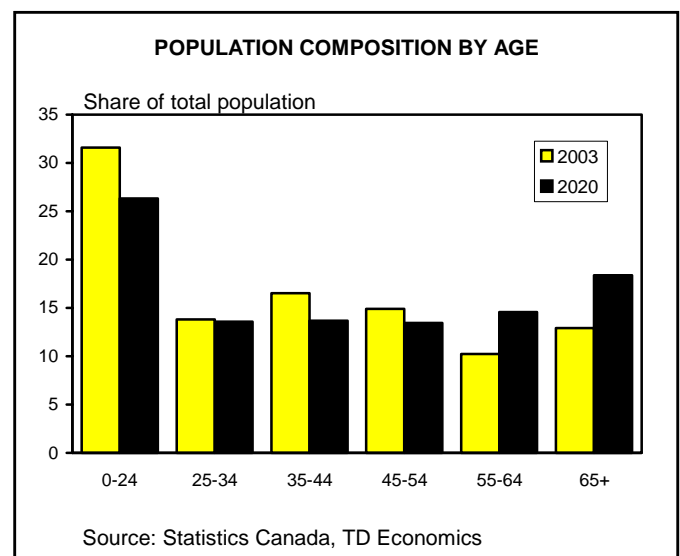
Traditionally, it has been thought that a surge in the older population will take up much of the slack in rental demand created by a declining younger generation. The 75 plus age group will soon become the fastest growing segment of the population, adding 1.4 million people to its ranks by 2026. And, history shows that about 20 per cent of these individuals will gravitate towards rental accommodations.

However, it will be important for rental investors to be in tune with their specific needs. In particular, older generations show a preference for high rises over low rises and since this will be the wealthiest older generation in Canadian history, demand may be more concentrated in higher quality units. Condos appear to fit this bill, once again highlighting the importance of secondary market competition.

And, recent patterns suggest that the proportion of renters in this older age group may taper off in the coming decades. The older generation is living longer and healthier than ever before, and, therefore, is less inclined to shift from family homes to rental accommodations. Between 1996 and 2001 – long before historically low interest rates enticed a greater number of people into the ownership market – the age specific propensity for people to rent declined in every age group, but the largest reduction occurred in the 65 plus population (as much as 3.8 percentage points). If this pattern continues, the rental market may be confronted with less demand than originally thought.

Immigrants: the new kid on the block

New immigrants will provide the greatest opportunity to fill in the rental gap created by a dwindling younger generation and a more rooted older generation. Immigrants will drive all of Canada's population growth by 2020, accounting for 119 per cent of the total annual rise. Since the vast majority of all new immigrants rent their accommodations for the first few years after arrival, this will provide solid underpinnings for continued rental demand. However, it will also accelerate the urbanization process in

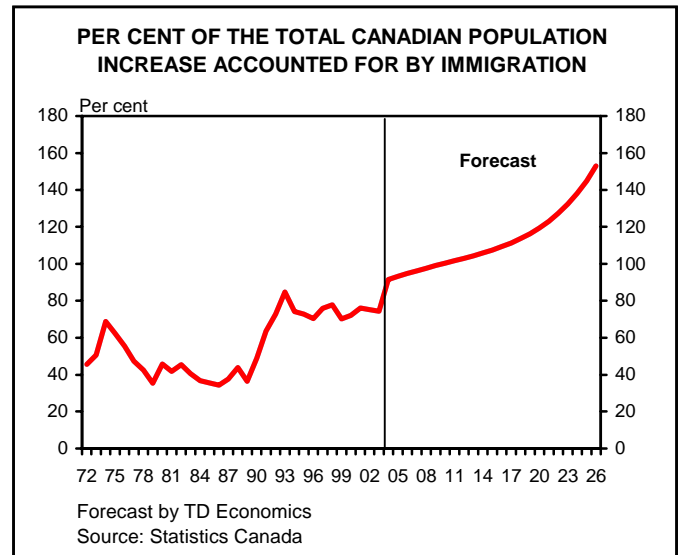


Canada, since most immigrants settle within three large city centers of Toronto, Vancouver and Montreal. In addition, recent immigrants have been faring much worse economically than both Canadian-born workers and previous generations of immigrants. This is largely due to a lack of literacy skills in Canada's official languages and the difficulty Canadian employers seem to have in evaluating prior work experience by immigrants in other countries. In any event, rental demand from this group will be hard-pressed to move beyond the "affordable" range of housing, which is already in scarce supply, and which provides little-to-no support for mid-to-higher priced units.

Government policies can hinder or help the process

In fact, there have been some poor policy decisions made on the part of government that could worsen rental conditions for new immigrants down the road. Although supply has increased for the broader rental market, that for the lower end of the rent range – the segment of the market where lower-income individuals with affordability problems are concentrated – has actually been receding. Investors have increasingly turned to the home ownership market for new development projects, in part because there have been significant changes in the policy landscape over the last several decades that are not favourable to rental investment (see TD Economics special report: *Affordable Housing in Canada: In Search of a New Paradigm*, June 17, 2003). These include federal tax reforms that made the tax treatment of rental properties less attractive for investors; declining federal and provincial government spending on housing; provincial downloading of responsibilities to municipalities; a tightening in CMHC's mortgage underwriting practices for rental properties; and, the existence of rent controls in a number of provinces.

However, the news isn't all bad and there have been some notable attempts to promote affordable housing. For instance, in November 2001, bilateral negotiations between the Federal, Provincial and Territorial Ministers gave birth to a five-year \$680 million framework, formally titled Affordable Housing Framework (AHF). Under this agreement, \$1 billion in federal investment would require matching funds by the provinces and territories with the goal of developing affordable housing and keeping it that way for at least 10 years. And, during the June 2004 election campaign, the Federal Liberals promised an injection of \$1.5 billion over the next six years for affordable housing.



Unfortunately, good intentions don't always translate into good deeds. For instance, Ontario's new Liberal Government may have unraveled new investment initiatives when they resurrected rent control measures in 2004 that placed a 1.5 per cent ceiling on annual rent increases. This is a particularly baffling policy decision because rents are already succumbing to downward pressure. And, in the long run, it will deter new development in the primary rental market. Given Canada's aging stock of current units, renters are more likely to face less choice and, perhaps, higher costs across all rental classes, placing additional strain on affordable options.

Investment rates, not like the old days

Rental investors should be prepared to accept lower rates of return going forward in comparison to the double-digit gains experienced in past years, and this will be the case across all rental investment classes, not just residential. This notion is not based on any shift in demand or aftermath of government policies, but rather, on the fact that Canada, and global markets in general, have entered an age of low inflation that will not support double digit returns. In a 2 per cent inflation environment – which is the Bank of Canada's targeted rate – long-term bond yields should average no more than 6 per cent. By comparison, the average return was almost 9 per cent in the 1980s when inflation ranged between 4 and 5 per cent. Over time, stock market values will be driven by the underlying profitability of the corporate sector, which, in turn, should rise in line with growth in overall Canadian nominal in-

come. With 2 per cent inflation and a real GDP growth rate potential of about 3 per cent – which may diminish further under an aging workforce – nominal income growth is unlikely to exceed 5 per cent. Accounting for the dividend pay-out ratio, overall stock market values are not expected to sustain growth of more than 6 to 8 per cent per year. Under these assumptions, there is little reason to expect residential investment returns to do any better.

Conclusion

All told, apartment rental investors will continue to wade through rough waters over the next 12 to 18 months. Vacancy rates in the primary rental market will likely rise

further in 2005 as new condominium supply continues to enter the market, both for homeownership and as a rental option. However, national vacancy rates are bound to return to a balanced market of 2 to 2.5 per cent in the years that follow, as higher interest rates erode home affordability and as the impact from the recent construction boom in condominiums diminishes. On a longer-term horizon, investors will face a host of new challenges and opportunities, as immigrants become the primary source of rental demand, while an aging home-grown population will require more focused initiatives in the area of high rises, retirement homes and “lifestyle” complexes.

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