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Weakening rental picture latest condo market worry

By Tara Perkins
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Report finds big jump in units available for rent and squeezed returns for landlords in Toronto

There are signs that rents in Toronto's condo market are on the verge of decreasing, at a time when new landlords are already dealing with low returns, a new report says.

The idea that the condo rental market might be tipping in favour of renters runs counter to the general belief among economists and industry experts that the condo rental market is strong, and that rents are rising.

"We believe the rental market may be at an inflection point," says the report by ***Veritas Investment Research*** analyst ***Ohad Lederer***. "Our weekly review of condo 'for rent' postings on craigslist.org indicate an approximate doubling of the number of condo listings in late 2013 versus late 2012."

Toronto's condo market, with its abundance of cranes and construction sites, has long been a concern for policy makers in Ottawa. If it is indeed at an inflection point, that could have serious implications for the market.

"We believe recent claims of robust rental market increases should be taken with a grain of salt," the report says. "We looked at 47 buildings for which we were able to compare current 'for rent' postings to the data we collected as part of our October 2012 data sample. Within those 47 like-to-like buildings, controlling for unit size where possible, per square foot rents declined 1.6 per cent."

This comes at a time when someone buying a condo in Toronto as an investment stands a one-in-two chance of enduring negative cash flows each month of more than $200, according to the report.

"New condo landlords in Toronto today can expect going-in unlevered cap rates around, and often below, the dividend yield on a typical bank stock or residential REIT," it says. "Investor owners are accepting returns below available REIT yields despite the illiquidity, lack of diversification, and operational risks of owning a unit directly."

The report illustrates the potential implications of these factors in one worrisome chain of events: "In one possible scenario, the Toronto rental market may no longer absorb supply as it comes on-stream, resulting in lower rents and increasing cash outflows for landlords, who then decide to sell, at first in a trickle and then in a thunderous herd.

"In this scenario, condo prices could drop dramatically, given relatively small unit sizes that do not attract a wide segment of potential buyers and the already weak underlying fundamentals."

Veritas suggests that such a scenario would have implications for Canada's banks. "Banks with large relative exposures could endure higher loan losses," the report says. "[Bank of Nova Scotia], for instance, and [Canadian Imperial Bank of Commerce] have slightly larger uninsured condo balances relative to common equity.

"Concurrently, or independently, buyers of unfinished condos may have trouble closing, for a variety of reasons," the report adds. "Depending on market conditions, private developers may absorb significant losses, and banks that lend at high [loan-to-values] can be expected to share in those losses."

The researchers found that mortgage pre-approvals were not needed to buy condos, adding to the risk that some buyers who have bought condos that have not yet been built will not close on the deal.

A number of economists and industry experts suggest that the potential scenario ***Veritas*** spells out is a highly unlikely extreme, but they concur with the notion that the condo rental market in Canada's most populous city will likely weaken to some degree over the next two years.

"I agree that the rental market will not be as strong in 2014, 2015," said Canadian Imperial Bank of Commerce economist Benjamin Tal. That's because the number of new condos coming on stream is forecast to be very high in the coming years.

"This is a market that hasn't been tested yet," he said. "And the test will be when we get extra supply in the next year or two, that's when you will test the willingness of investors to be in this market given that rents probably won't be rising at today's pace."

But he does not believe that there will be a crash in the rental market, and that's because he thinks young people will increasingly have to rent rather than buy.

"Young people now cannot afford to buy a house," Mr. Tal said. "Even young married couples. They will be renting more than buying. I think Canada's homeownership rate of 70 per cent has peaked."

Shaun Hildebrand, senior vice-president at condo research firm Urbanation, expects upwards of 20,000 new condo units to come on stream annually over the next three years.

"I don't disagree with the fact that we probably are not going to see this type of growth in rents and rental demand continuing along the same path it's been on," he said. "I think we're going to start to see it level out."

But he says that even if vacancy rates double or triple, they will still be relatively low, and rents tend to be "sticky" so they might not fall.

"One of the things that's obviously been helping investors hold onto their units is the fact that rents have been continuing to grow, keeping their cash flow marginally positive," he said. "Moving forward it's going to be more difficult. We may see more investors turn to sell than they have been ... It's going to be a bit of a bumpy ride between 2014 and 2016."

Toronto condo developer Barry Fenton, CEO of Lanterra Developments, says the industry remains confident in the condo rental market.

For one thing, he noted that he and many other developers are now offering investors rental guarantees when they buy units in buildings that haven't been built. At the Britt condos, Lanterra sold 100 units to investors with a guarantee that they'd obtain more than $3 per square foot in rent for two years, or Lanterra will pay it, Mr. Fenton said. "We're not here to lose money," he said.

He added that he's in talks with a pension fund that wants him to develop a building with 1,000 units downtown that the pension fund would initially rent out, but could later sell as condos if it chose.

"You wouldn't have astute pension funds putting out a lot of money to invest in the condo rental market unless they were confident," Mr. Fenton said.