Apartment Market Update

2016 was a very interesting year. Capitalization rates were largely stable as a whole, but the market was very aggressive in paying premium prices to buy properties. Competition was intense and reasonably priced opportunities were few. Trading was very active. These pricing constraints meant that Centurion Apartment Real Estate Investment Trust (the "REIT") bought very little in 2016. The REIT's purchases in the past 18 months were either not widely marketed properties or came from the REIT's lending and development platform through Centurion Real Estate Opportunities Trust (the "REOT").

In Toronto, vacancy rates are below 1% and rents have started to rise very quickly. In the condo market, rents are reported as having risen by almost 12% in the year. We are aware of a number of condo rentals being done via auction (i.e., you bid the rent you are willing to pay). This demand is spilling into the purpose-built market as well and we are seeing rents move strongly. In our own portfolio, effective availability is near zero in the Toronto area, with some available units attracting over one hundred appointments per available unit.

Demand for housing, whether owned or rented, in Toronto is intense. The roaring price of real estate is pricing out renters from moving into ownership and driving up rental demand that would have been reduced by upgrades to ownership. The demand has forced down vacancy rates, and reduced resident turnover dramatically. Where normally we would expect resident turnover rates of 20-30%, it seems that this may now be closer to 15%. Because sitting residents in purpose-built apartments benefit from rent control (if the building was built pre-1992), they are now locked into staying in their unit because: (1) there is little availability of rentals to move to because no one is moving and there is so much demand, and (2) if they do move, their new rent is likely to be materially higher than they are paying now.

Politicians, ever opportunistic, have sensed a new crisis to "solve" with new regulations to "protect" tenants. There have been numerous stories of rents rocketing for renters of condo units because these are exempt from rental control. While this has been described by various groups as a loophole, it is anything but. The post-1991 exemptions for new rental unit construction were put into place to reverse the disastrous decline in the amount of purpose-built rental properties constructed after rent controls were introduced. Due to the volatility of rent control legislation, developers, rightly so, distrusted the politicians. More importantly, they discovered a new opportunity – building and selling condominiums. For those of you old enough to remember Toronto in the '70s, almost all high-rise residential buildings were rental buildings. If you were in a high-rise, you were a renter, not an owner. Most people who wanted to own, saw ownership of a detached home as their goal. While there are a whole bunch of reasons why there are a lot of condos in Toronto today compared to the 1970s, a good part of the reason is because of the shift in what builders could make work based on economics and politics. They were forced to stop building rentals due to these economic and political reasons and instead they built condos. In other words, the market responded to the regulations, just not in the way that the politicians had intended. Ahh yes… those unintended consequences.

Nothing destroys cities more than rent controls, with the sole exception being bombs. If you make it impossible to earn a decent return on supplying any product, whether housing, food, or iPhones, then nothing will be produced and supply will become even more constrained, achieving the exact opposite of what is required… more supply.

Imagine if government told grocery stores to sell food for less than their costs because of the perception that food costs are too high, and that food security at a low price is a basic human right. The grocery stores will either close or be forced to cut quality or costs. No one would open a new grocery store. No matter what, supply goes down, making all consumers worse off.

Calls for rent control in Ontario have risen considerably recently as a result of rapidly rising rents due to a housing shortage. The NDP has proposed a private members' bill to introduce controls on product built post-1991. The Wynne liberals, facing armageddon at the polls in 2018, are desperate for a boost and there are more renters than landlords as voters. Even the Conservatives seem supportive for some sort of controls.

On April 20th, the Ontario government announced 16 measures designed to cool the market as part of their "Fair Housing Plan". Among them, the most significant, are rent controls on post-1991 constructed apartment buildings, a 15% tax on foreign investors, and a $25 million per year over five years to fund new apartment construction through development charge rebates. Most importantly, they did not change the "vacancy decontrol" rules, which allow landlords to raise rents to the market when a tenant moves out. For owners of buildings built pre-1991, which is most of the apartment stock, this means nothing has changed except there will be less supply of apartments to compete with.

So here are the some of the potential unintended consequences, as we see them, of rent controls on new rental, assuming this legislation is passed. The rise in market rents has spurred the construction of new rental product. Supply is having trouble keeping up with inbound immigration and the slow pace of approvals, but it is coming. Introducing rent controls on new product will potentially dramatically reduce this supply. At Centurion, when we model a proposed new apartment building, we model rents rising at the same rates as inflation. Thus, introducing rent controls does not significantly impair our modelled returns in the markets we focus on, which are outside Toronto proper. Many, however, will be turned off, and convert their apartment to a condo and sell it instead.

In our financing and development portfolio, many of the properties that were being built as rental apartments are being now being sold or intending to be sold as condominiums due to the run up in condo prices. Up to this point, the rationale has not been political but pure economics. Valuations as condominiums have advanced on some projects so much that it makes more sense to sell them as condominiums than to keep them as apartments. This is part of the reason for the REOT's outsized returns in 2016 of around 15%. It is also the reason why we expect the REIT to buy less of the development properties that the REOT is financing as the market price in many cases far exceeds what the REIT is willing to pay. As a result, we will be opportunistic to buy at prices that make sense or to let the properties be sold in the market for more.

The Toronto market is the one under the most strain and it is here where the most supply is desperately required. In these markets, the alternative is to build condominiums and with constrained rents, the incentives to build new rentals will collapse versus the alternative of returning to building condos if rent controls on them are established. Developers rely on pre-sales in order to obtain construction financing. Banks often want at least 80% of the building to be pre-sold before a developer may draw on their financing. Given that most condominium sales in the GTA are to "investors", the introduction of complicated legislation regarding rent controls may cause investors to look elsewhere. All that is required is for the perception of investors to change about the investment climate and the willingness of investors to buy could drop dramatically. The result could be that without condo pre-sales, fewer condos will be built and given that these have provided a lot of supply of rentals and affordable housing to the market over the years, this would only serve to worsen the housing availability crisis. Toronto has been here before in the '80s when vacancy rates touched 0.2% and people found it impossible to find an apartment and whole segments of the lower income population were locked out of the market.

We are watching these developments and it remains uncertain whether rent controls, if implemented, will reduce or increase our investment opportunities. There may be dramatically less development overall, and given we have been active in this area, that would be a disappointment. However, even with a shrinking market, it may mean that traditional lenders retreat further from the market, meaning that the opportunities for nimble investors may increase. We will look to position the portfolio as appropriate.

We anticipate that the impact on our existing portfolio will not be significant. Like other landlords in Ontario, a good chunk of our portfolio is pre-1991 construction, meaning that the new rules don't affect us. However, we do have quite a bit of new apartments, mostly in the student space. Because these residents move out as they graduate, we expect that rent controls will have virtually no impact on the student housing business. For new apartments that we own, the rent up process has now been made much more complicated (as you may not ask full rents during lease up, preferring to stabilize the building then move rents to market rates later). We anticipate that these technical details will be worked out in the legislation and in any case, we will adapt accordingly.

The GTA has a housing availability and affordability crisis of its own making. Interest rates and foreign investors are only part of the problem. Other problems include, but are not limited to:

- The greenbelt severely restricts where the city can grow.
- Poor transportation infrastructure makes it difficult to commute, driving up demand for property inside a reasonable commuting zone.
- Excessive development charges make it expensive to build and reduce the feasibility of building rentals.
- Lengthy development processes increase the costs and risks of development, and slow the ability of the development community to meet demand with supply.
- Discussion of rent controls will shut down development and force rents immediately higher as owners' fear that they won't be able to raise them in the future.

So rather than just throw stones, we propose some possible solutions:

- Improving transportation infrastructure, which would make it easier to commute from greater distances. For reference, Japan has high-speed rails that currently go up to 320 km/hr, with new lines being brought into production that can go up to 500 km/hr. This would put Montreal inside the average commute time for Toronto residents. Expanding the commuting radius would take significant pressure off housing prices and create prosperity in surrounding areas;

- Cutting development charges for rental housing construction would increase the attractiveness of building rentals versus condos;

- Property tax holidays and/or phase-ins on rental apartment construction would similarly increase returns to building rentals;

- Increased density bonuses on development sites when apartments are built (e.g., if normal density is for 300 units on a site, permission would be given to build 400 units but at least 100 of them must be purpose-built rental);

- Increased expropriation along public transportation routes for high-density development which would free development land and also make it easier to assemble sites;

- Loosening zoning and density restrictions along the development routes identified; and

- A severe change in attitude regarding development by the NIMBY crowd and politicians' willingness to listen to them. Yes, no one likes a giant tower casting a shadow over their house but that new tower could house 1,000 people and we will not find solutions if everyone who does not like something can stop it. Multiply the above by the thousands of sites we have to densify in Toronto, and we have reasonably priced housing for millions in the city and a model for the future.

The above being said, I have little confidence that any of these proposals will happen. Instead of trying to create supply, politicians will continue to try to choke demand for housing through regulations which, so far, just has not worked. It is time that a new approach be tried.

On the positive side of regulation, Ontario has frozen property taxes on apartments and cut hydro rates by 25% which will help us continue to drive margins in 2017.

Greg Romundt