CURRENT ANALYSIS

July 2012

Booming Toronto condo market does not imply a bubble

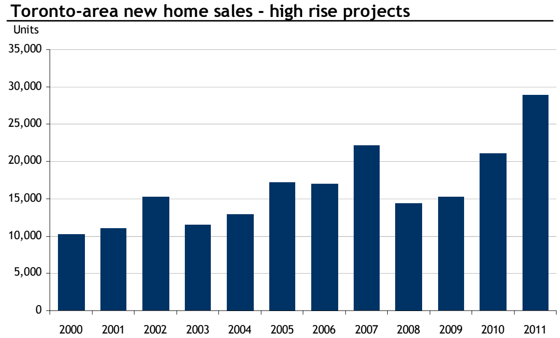
The army of cranes redefining the Toronto skyline—Toronto reportedly counts the most high-rise real estate projects under construction in North America—is said to be evidence of a housing bubble at play in Canada's biggest urban area. Record-high sales of new condominium apartment last year raised concerns all the way to the top level policymakers in Canada. In this report, we find that while it is true that condo sales and construction are booming, such observations are less worrisome when considered within in the broader housing context in the area. The Greater Toronto Area (GTA) has undergone a structural shift in its housing mix whereby record-new condo sales have picked up slack left by fewer single-family homes being built. Based on market activity to date, the total number of new housing units (condos, single-family homes, and others) completed by builders has not exceeded the GTA's demographic requirements and is unlikely to do so by any significant magnitude in the next few years. The strong presence of investors in the condo market raises the risk of a mis-match among the types of units supplied and ultimately demanded for oc-cupancy, but, at this point, we do not equate this risk with a bubble.

Constraints on developing 'laterally'

To a large extent, the surge in condo developments reflects a structural shift in the GTA housing mix (high rise compared to singe-family homes) brought about by increasing constraints on, and costs of, developing 'laterally'. Many of these constraints are linked to the Ontario government's Growth Plan for the Golden Horseshoe (dubbed 'Places to Grow'), which was introduced in 2006 and is still being rolled out in the GTA. Among other things, the plan aims at curbing urban sprawl by imposing intensification targets on municipalities located in the Golden Horseshoe region. To accommodate the 38,000 or so net new households it sees every year, the GTA must increasingly expand its housing stock 'vertically'. The shift toward 'vertical' development, in fact, pre-dates Places to Grow, as construction of single detached homes has been on a downward trend in the past 10 years. Considering that single home starts are now running at about half their level 10 years ago, we note that the sharp increase in condo starts since the recession lows of 2009 has not yet pushed overall housing starts beyond previous construction booms in the GTA (Exhibit 3).

Exhibit 1

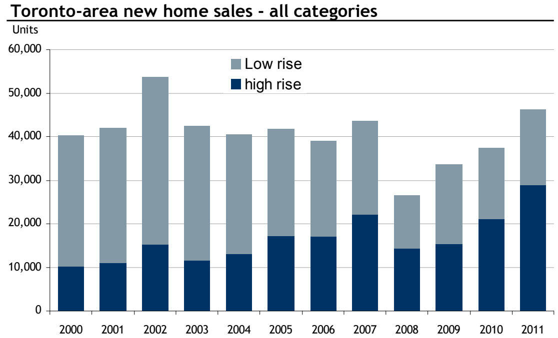
Toronto-area new home sales - high rise projects



Source: RealNet, RBC Economics Research

Exhibit 2

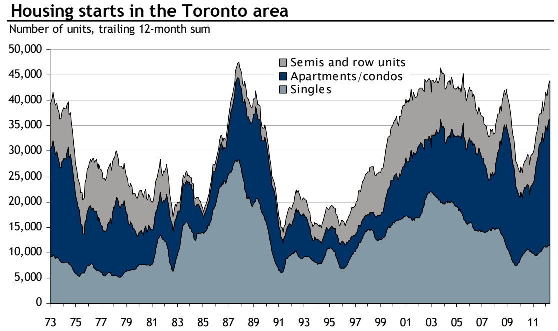
Toronto-area new home sales - all categories



Source: RealNet, RBC Economics Research

Exhibit 3

Housing starts in the Toronto area



Source: CMHC, RBC Economics Research

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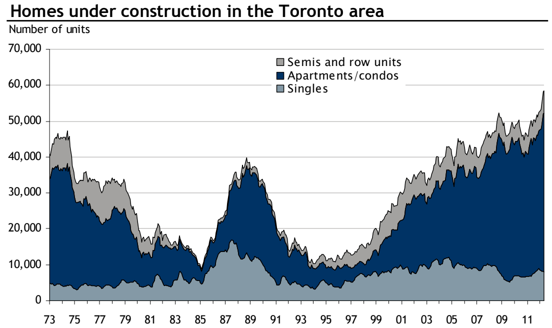
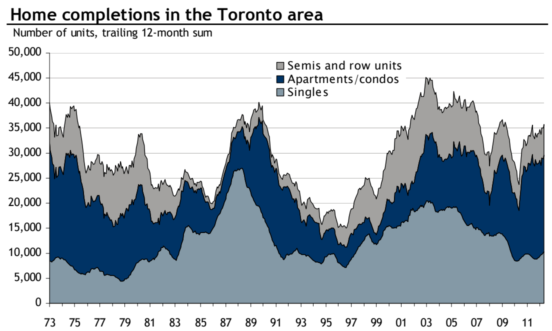
Exhibit 4



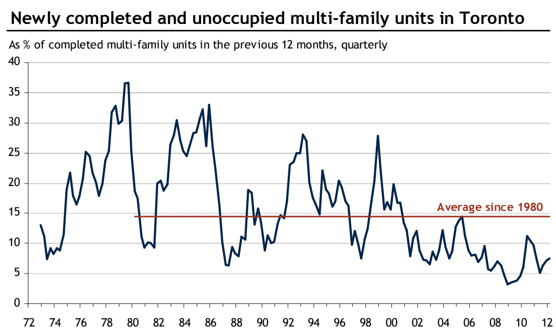
Source: CMHC, RBC Economics Research

Exhibit 5



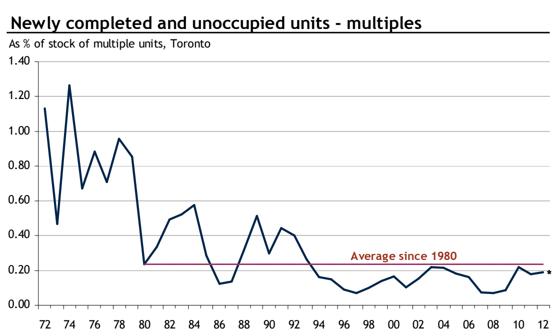
Source: CMHC, RBC Economics Research

Exhibit 6



Source: CMHC, RBC Economics Research

Exhibit 7



* Estimate at first quarter 2012.
Source: CMHC, Statistics Canada, RBC Economics Research

A lot of condo construction underway

To be sure, there is a lot of condo construction underway at the moment. The latest figures from Canada Mortgage and Housing Corporation (CMHC) show that a record 44,100 condo and apartment units were under construction in May of 2012, with an additional 6,200 other 'multiple' units (semi-detached and row houses) (Exhibit 4). All in all, the Toronto region has never seen so much new residential construction (at least based on data going back to the early 1970s). It is important to keep in mind, however, that the construction cycle for condominium projects is long—up to three years. This means that, at any point in time, there are necessarily more multi-unit projects underway concurrently than there are for singles (the construction cycle of which is measured in months). The rapidly rising trend toward multiples starts in the past many years, therefore, has filled up the construction 'pipeline' in the Toronto area considerably. In this context, record-condo construction, in and of itself, is not proof of any excess. Looking at the end of the building pipeline, however, we note that the number of condo units reaching completion indeed is rising quite rapidly (and has been so during most of the past decade), but this increase is taking place while single-home completions have become a much diminished factor in the GTA. Total home completions for all housing categories in the area remain well below historical peaks (Exhibit 5).

Few newly built condos are sitting empty

Concerns that large numbers of newly built condo units are sitting empty are simply not supported by the statistics. Quite the contrary, newly completed but unoccupied multi-family units are historically low when expressed as a percentage of recent completions (Exhibit 6) or as a share of the housing stock of multiples in the GTA (Exhibit 7). Unoccupied condos lately represented approximately 7.5% of the condo units completed in the previous 12 months or almost half the average since 1980. We estimate that unoccupied units represented close to 0.2% of the stock of multiple units in Toronto, which also was less than the average since 1980. The vast majority of condo units delivered by builders is finding occupants.

New housing units to remain in line with demographics

Newly built condo are most likely to continue to find occupants in the period ahead. Demand for occupancy in the GTA is strongly supported by demographics. Population growth in the area is approximately 100,000 per year. This translated into an average of 38,000 new households per year during the period between the 2006 and 2011 population censuses (Exhibit 8). Using the lagged relationship between starts and completions for multiples (Exhibit 9), we believe that completions of multi-family units could rise as high as 25,000 units annually in the next two to three years, although such levels would likely challenge builders' production capacity. This expectation is broadly in line with RealNet's estimated unit delivery schedules. While the relationship between starts and completions for singles (Exhibit 10) does not provide guidance for a period much further than the next few months, we assume that singles completions will remain stable or rise only slightly in the coming years. If household formation stays fairly flat, we find that total housing completions in the GTA will remain roughly in line with demographic requirements during the next two to three years (Exhibit 11). In other words, under a reasonably steady demographic scenario, we are unlikely to see overbuilding taking place in the GTA.

Weaker demographics would test the market's absorption capacity

Under a weaker demographic scenario, however, the GTA market's capacity to absorb the new supply could be tested. Nevertheless, unless household formation dips substantially, we would not expect the emergence of any oversupply reaching levels that would threaten the stability of the market.

Concerns about condo investors may be overblown

We find that concerns about the actions of investors and/or speculators may be somewhat overblown or, at least, premature. To be sure, investors play a significant role in the new condo market segment, constituting a large share of condo buyers lately—the precise share is difficult to estimate because comprehensive data is lacking; however, a sample of recent projects showed that investor presence ranged between 15% and 40% for most projects, and could be 60% or more in some instances. For the most part, investors have tended to be individual owners who place their units in the rental pool with the goal of generating rental income. We find little evidence of speculation (property 'flipping') on any dangerous scale—CMHC reported last fall that only 10–15% of new condos are listed for sale within 12 months of registration. To date, the presence of investors and speculators has not been detrimental to the GTA market. As mentioned, their involvement has not inflated overall housing demand beyond household formation and may contribute only to a modest overshoot in the coming years if demographics weaken. Investors and speculators, in fact, played an important role in helping condo projects through their 'gestation' period by, in effect, providing construction financing (via the initial deposit to secure the purchase).

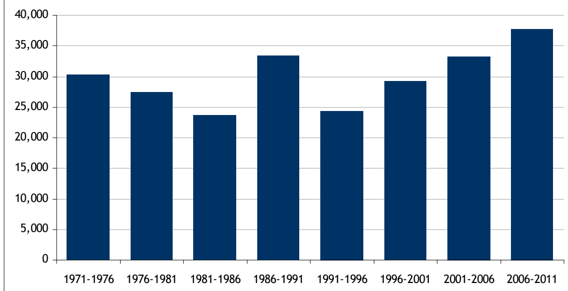
Condo investors address tight availability in the rental market

Furthermore, investors' actions have benefited the rental side of the market by addressing very low rental unit availability in the area. The GTA rental market has long been tight because there have been very few new purpose-built apartment projects constructed in the past two decades in the Toronto area. Condominium apartments have become the biggest source of new rental units in the GTA (and elsewhere in Canada). Recent additions of new condo units to the GTA rental pool have been fully absorbed by the market. The rental vacancy rate even edged down to 1.1% last year (Exhibit 12) despite an outsized (18%) increase in condo rental units (Exhibit 13), which is quite telling of the rental demand strength.

Exhibit 8

Household formation in the Toronto CMA

Average number of new households between censuses

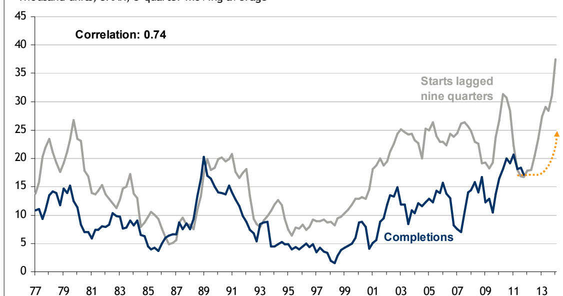


Source: Statistics Canada, RBC Economics Research

Exhibit 9

Toronto multiple unit starts vs.completions

Thousand units, SAAR, 3-quarter moving average

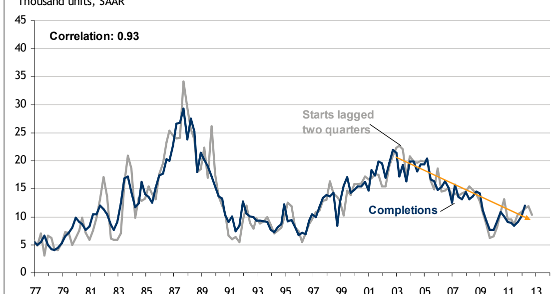


Source: CMHC, RBC Economics Research

Exhibit 10

Toronto single unit starts vs.completions

Thousand units, SAAR

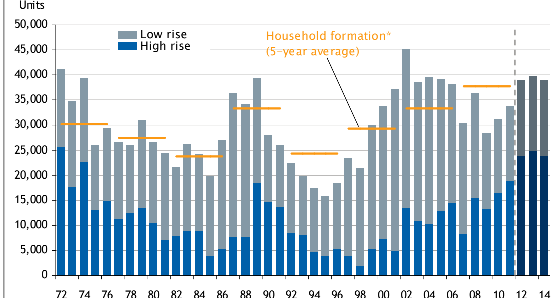


Source: CMHC, RBC Economics Research

Exhibit 11

Housing completions in the Toronto area

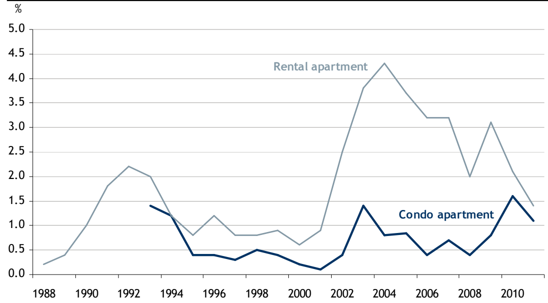
Units



* Average annual increase in number of households between censuses.
Source: CMHC, Statistics Canada, RBC Economics Research

Exhibit 12

Rental vacancy rates in the Toronto area



Source: CMHC, RBC Economics Research

Exhibit 13

Toronto CMA rented housing stock

Number of units

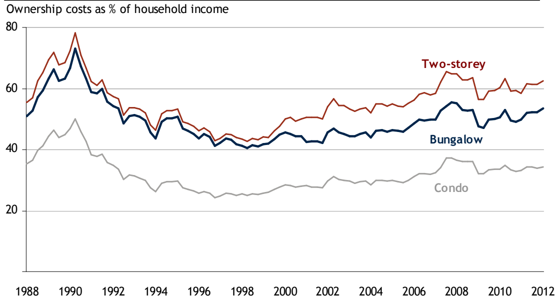
	2010	2011	Change in %	Change in units
Units in purpose-built rental apartment buildings	306,091	307,171	0.4	1,080
Secondary rented units (single detached, semis, others)	116,469	121,843	4.6	5,374
Rental units in condo apartment buildings	50,595	59,854	18.3	9,259
Rental row houses (townhouses)	7,902	7,862	-0.5	-40
Total rental units	481,057	496,730	3.3	15,673

Source: CMHC Rental Market Survey, Fall 2011; RBC Economics Research

Exhibit 14

RBC Housing Affordability Measures for the Toronto area

Ownership costs as % of household income

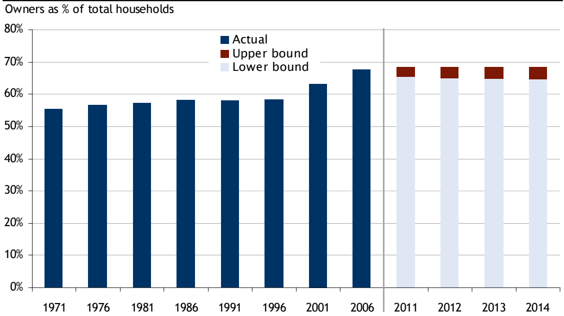


Source: Statistics Canada, Royal LePage, RBC Economics Research

Exhibit 15

Ownership rate in the Toronto area

Owners as % of total households



Source: Statistics Canada, CMHC, RBC Economics Research

Investors could overestimate future demand for condos…

So are concerns of a condo bubble in the GTA unwarranted? They could in fact be warranted *if* the strong and growing presence of investors distorts market signals. If too many investors make wrong calls on the types of units that will ultimately be occupied, thereby inflating demand for certain classes of apartments, this could lead to oversupply in specific market segments (e.g., small one-bedroom apartments). The risk of major imbalances arising will, thus, ultimately depend on the degree to which the supply mix will manage to match the unit-type mix actually demanded for occupancy.

…but not by much

While there is a risk that investors might be miscalculating the future composition of underlying demand, we think that they are right in expecting stronger rental demand in the years ahead. Rental demand will be well supported by demographic factors—growth in the prime rental age group (25-35) in the GTA is projected to be strong in the next few years as the echo boom effect runs through that population cohort. More importantly, perhaps, is that the financial ability of households to own a home in the GTA will be increasingly challenged at a time when mortgage insurance rules will become tighter and the Bank of Canada should proceed with renormalizing interest rates starting early next year, as we anticipate. Shorter amortization periods on new insured mortgages and gradually rising interest rates will put some strain on housing affordability (Exhibit 14), raise the ownership bar somewhat, and redirect a growing proportion of households toward the rental market.

Easing ownership rate will boost rental demand in the GTA

Because of such pressure on affordability, the ownership rate (referencing all housing categories combined not just condos) in the Toronto area, therefore, may well stabilize or even ease in the years ahead (Exhibit 15)—following the substantial increase that took place during the late-1990s and part of the 2000s, which worked to divert demand for occupancy away from rental units during that period. It is difficult to ascertain with accuracy the current and future sizes of demand for rental units in large part because we lack up-to-date estimates of the number of owners and renters in the Toronto area (the last reliable data are provided by the 2006 Census). We, however, believe that the range could be between 10,000–18,000 total units (i.e., for all housing types) per year for the next three years (Exhibit 16), assuming household formation remains close to recent levels. The mid-point of 14,000 units would nearly match the average increase in the number of renter-households during the latter half of the 1980s, which stands as the high water mark in the past four decades. The 10,000–18,000 unit range would represent 25–45% of total housing completions if completions were to hover around the 40,000 unit level, as we anticipate. Given that approximately three-quarters of rental demand is for high-rise multi-family units, we believe that the range of new renters for this housing category could constitute between 30–50% of multi-family unit completions in the coming years.

Factors could mitigate the risk of oversupply

The factors that could lead to market excesses have received the most attention lately. It is important not to forget, however, that other factors could work to lessen the risk of any significant imbalances forming in the GTA housing market. On the demand side, household formation in the area could be stronger than it has been in recent years. In fact, if the trend of the past 15 years continues, household formation could well exceed the 38,000 average registered in the five years ending 2011 (based on Census data)—a simple extrapolation would suggest a level above 40,000.

Not all proposed condo projects may go forward as planned

On the supply side, not all condo projects currently at the pre-construction stage and contributing to the new home sales statistics last year and early this year may go forward as planned. Some projects may be delayed or cancelled, thereby diminishing the risk of a sudden wave of condo units flooding certain segments of the market at some point in the future. Possible reasons for such delays or cancellations include production capacity constraints on the part of builders, the inability of projects to reach sales thresholds necessary to move forward with construction, and tighter lending standards for builders. On the latter reason, there is evidence that financial institutions are now displaying greater scrutiny in evaluating projects that they will finance. Both banking regulators and risk management functions within financial institutions have been monitoring exposure to the Canadian housing sector more closely. Financing constraints, therefore, may work to ration future new condo construction to some degree.

The absence of a bubble does not mean prices will keep rising

If we are not in the presence of a bubble, does it mean that prices will keep going up in the Toronto area? Not necessarily. In fact, we expect the current upward pressure on home prices to ease substantially by next year, with condo prices possibly coming down a notch or two (perhaps easing by 2–7% from quarterly peak to trough). We expect increasing relief from the tightness that characterized the GTA existing home market during most of the past year and a half (Exhibit 17)—when it was essentially a sellers' market—as more new condo units are completed (and find their way into the supply of existing homes for sale) and homebuyer demand cools amid tighter mortgage insurance rules, rising interest rates, and eroding housing affordability.

Condo speculator and investor enthusiasm likely to dim

In addition, we expect that demand from condo speculators (those who bought at the pre-construction stage and looking to 'flip' their unit on delivery or shortly thereafter) will wane as the prospects for further strong value appreciation diminishes. Even demand from condo investors may soften if the rent and/or carrying-costs equation deteriorates and makes such investment less attractive. Based on RealNet calculations, depending on the

Exhibit 16

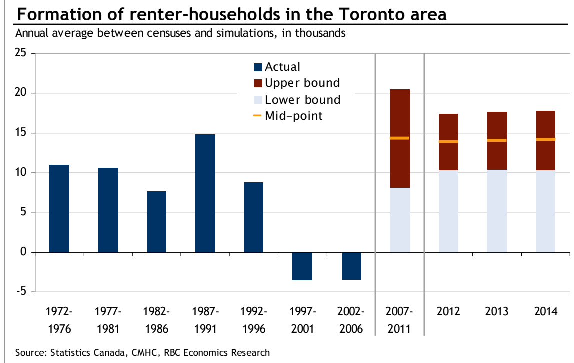


Exhibit 17

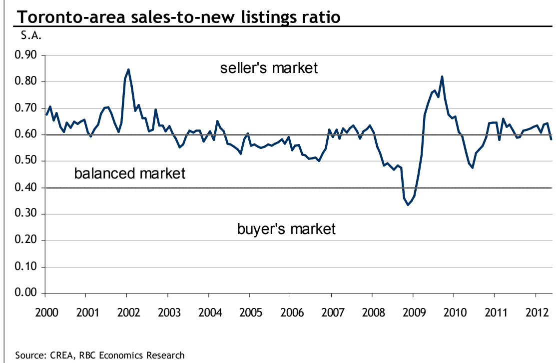


Exhibit 18

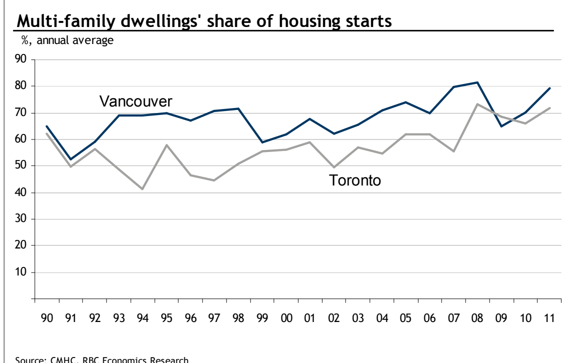


Exhibit 19

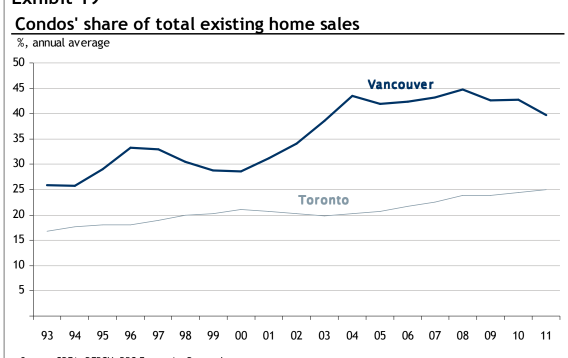
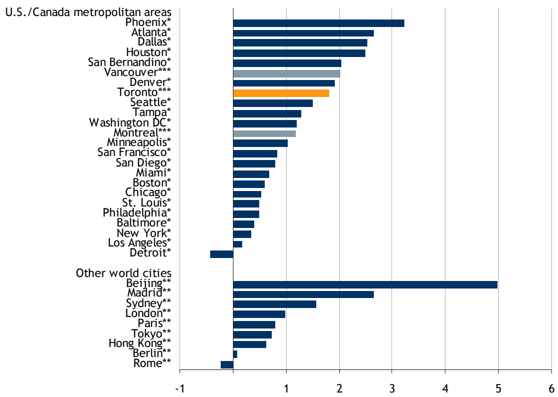


Exhibit 20

Population growth in major metropolitan areas

Annual average % change in the last five years



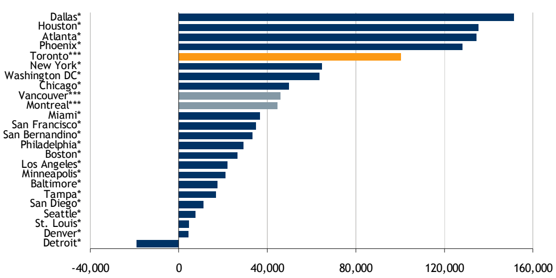
* Five-year period ending 2009.
** Five-year period ending 2010.
*** Five-year period ending 2011.

Source: Statistics Canada, US Census Bureau, various national statistical agencies, RBC Economics Research

Exhibit 21

Population growth in major U.S. and Canadian metropolitan areas

Annual average change in the last five years, number of people

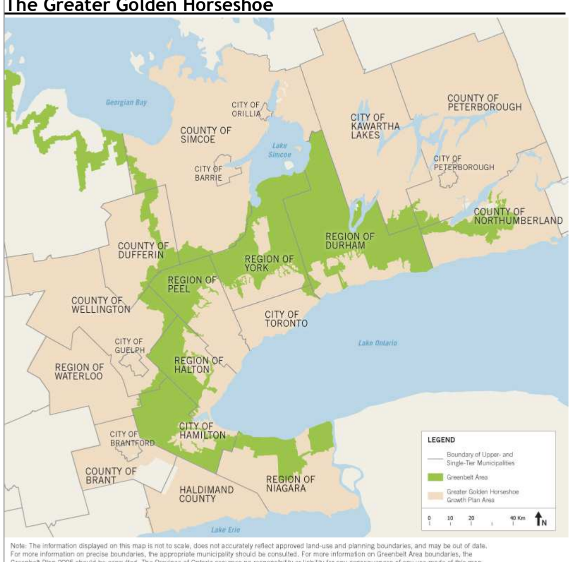


* Five-year period ending 2009.
*** Five-year period ending 2011.

Source: Statistics Canada, US Census Bureau,RBC Economics Research

Exhibit 22

The Greater Golden Horseshoe



Source: Ontario Ministry of Public Infrastructure Renewal

amount of leverage used in the purchase and speed with which interest rates will rise in the coming years, rent must increase anywhere between 3–14% per year for a condo investor buying at today's pre-construction price (in the downtown area) to break even once the unit is rented out, possibly four years from now. This range of rent increases may be difficult to obtain considering that market rent of condo rental apartments in the Toronto census metropolitan area (CMA) levelled off last year following a rise exceeding 7% in 2010 (based on CMHC data)—the average increase in the past two years was approximately 4% per year. The Toronto Real Estate Board reported that rents for condo rental leases transacted through the Multiple Listing Service (MLS) system rose between 4% (one bedroom) and 7% (two bedrooms) year over year in the first quarter of 2012.

Two-tiered market emerging?

While we expect the combination of factors from both the demand and supply sides to apply downward pressure on condo prices, we believe that market conditions will provide comparatively stronger support for single-family home prices. With so little construction of new, single, detached units taking place, supply will remain limited relative to demand in this segment of the Toronto-area market—a situation that usually applies upward force on prices. In effect, we could well see the emergence of a two-tiered market: a soft condo segment, and a resilient single-family home segment. Recent price data already give hints of such a split, as detached home prices have been outpacing those for condo apartments by a significant margin so far this year.

Conclusion: no bubble but still some risks

The historic condominium apartment boom in the Toronto-area market is not necessarily a sign of excess or of a bubble. To a large extent, it reflects a structural shift that has taken place in the GTA housing mix, whereby constraints on lateral housing development (single-family homes) has led to greater emphasis on vertical housing development (high-rise condominiums). While it may not be due to a bubble bursting, nonetheless, we expect that buyer demand for condos will cool going forward. We believe that the latest changes to mortgage insurance rules, upcoming interest rate increases, and waning enthusiasm from investors and speculators will reduce the flow of condo buyers in the market. In fact, there is evidence that this slowing in activity has already begun, as sales of high-rise units in new condo projects fell in the first five months of 2012 relative to the same period in 2011—sales of new low-rise (primarily single-family) units, meanwhile, have held up so far. We think that diverging demand-supply conditions for the condo and detached home segments will set the stage for a two-tiered market in the GTA. The biggest risk that we see for the coming years is a possible mismatch between the types of condo units bought by investors and the types ultimately demanded for occupancy, which could lead to oversupply in certain condo sub-segments. The fact that overall housing construction (all housing categories considered) is unlikely to depart from household formation in the GTA reduces the risk of a wholesale collapse of the market.

Appendix I – Toronto's strong demographics

The Toronto area is one of the faster-growing world cities. At an annual average of 1.8% in the past five years, the rate of population growth in the GTA exceeds that of such major metropolitan areas as New York, Chicago, London, Paris, and Hong Kong (Exhibit 20). Among the largest US and Canadian cities, Toronto's rate of population growth is surpassed by only a few other areas (including Vancouver). With its population increasing by approximately 100,000 per year, Toronto is surpassed by even fewer areas in level terms (Exhibit 21). Consequently, demographic requirements for housing are strong in the GTA on a relative basis, and we should not be surprised by the elevated levels of housing construction—particularly of high-rise condominiums—compared to other Canadian or US cities.

Appendix II – Ontario's Places to Grow Act

In response to concerns about urban sprawl in the Golden Horseshoe region—where population is projected to grow at one of the faster rates in North America—the Ontario government passed the Places to Grow Act in 2005. The main upshots of the Act were the establishment of a 1.8 million-acre 'green belt' across the region (Exhibit 22) and a 25-year growth plan for the region (the 'Growth Plan for the Greater Golden Horseshoe', released in 2006). The creation of the Growth Plan was a watershed event that, among other things, set new rules for official municipal land development plans.

Under the plan's policies, all regions, counties, and single-tier municipalities in the Golden Horseshoe will have to accommodate, by 2015, a minimum of 40% of new housing within their respective existing built-up areas through infill, redevelopment, and intensification. The plan includes population density targets for 25 downtowns, which vary according to each downtown's stage of development. Official municipal development plans are also required to provide protection for green fields and lands that support employment uses.

Implementation of the Growth Plan is now well underway at the regional, county, and municipal levels, and this has shaped the type and location of housing construction that has taken place in the GTA and other regions of the Golden Horseshoe in the past several years. Resulting amendments to official municipal plans have generated some uncertainty, however. Such amendments to official plans or portions thereof are under appeal before the Ontario Municipal Board (OMB) in many jurisdictions. Consequently, the land development approval process is in a state of flux in those jurisdictions, which may hamper expansion of building land until OMB or other court decisions clarify the rules.