SPECIAL REPORT
TORONTO HOUSING AFFORDABILITY

INSTITUTIONAL PROPERTY ADVISORS
A DIVISION OF MARCUS & MILLICHAP, BROKERAGE

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Government Policy Impeding Development, Impacting Housing Affordability

Feasibility becoming a challenge for residential developers. Construction costs in Toronto have risen 50 per cent since 2018, stemming from external factors unleashed during the global health crisis and internal factors from local policy makers. While external elements should dissipate, the internal aspects will likely be more challenging to overcome. As costs continue to rise while revenues plateau, developers are questioning the feasibility of new projects. In the long term, this will likely further hinder housing affordability.

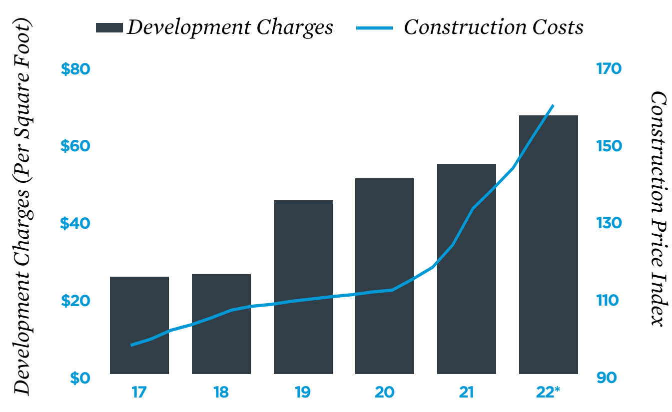
External components likely to mitigate. The global health crisis and the war in Ukraine have contributed to labour shortages, supply chain headwinds and rapid inflation. All of these have translated into higher construction costs and flattened revenue growth, causing profits to tighten and reducing the number of projects that can stand up to the minimum financial requirements that lenders are calling for. Toronto has already begun to see increased volumes of capital project cancellations, construction being put on hold, or outright land sales as developers walk away, hindering Toronto's long-term housing supply. Nonetheless, all of these external pressures will likely resolve. Supply chains are re-establishing, inflation slowed for the first time in June, and increased immigration should help alleviate a portion of the labour shortage.

Internal factors will likely remain a challenge. Construction costs are also elevated because of restrictive public policy. Toronto has the highest development charges of all major metros by a 25 per cent margin. The government also just announced it will be increasing charges by a further 46 per cent. Additionally, new inclusionary zoning policies are requiring developments to allocate 5-10 per cent of all units as affordable housing, increasing to 10-20 per cent by 2030. Lastly, new Green Standards were implemented in May, meaning multifamily developments must now meet higher sustainability requirements. Greenhouse gas emissions will have to be reduced by 25 per cent, and energy intensity needs to be lowered by 28 per cent. Although these policies are socially and environmentally beneficial, they all result in higher costs and the price for a condo would have to increase by $50,000 to cover these increased costs. With no government incentives or tax breaks to help offset these costs, the incentive to build is limited as questions arise surrounding the feasibility of new projects. This will result in further supply restrictions and upward price movements as developers likely move away from Toronto multifamily developments to more profitable projects.

Construction constraints hold true for Ontario as a whole. Canada's housing market is the most undersupplied among all G7 countries, and Ontario faces the greatest headwinds of all provinces. In order to meet the same level of houses per capita as the average of all other provinces, Ontario needs to add 650,000 homes. The province's goal to build 1.5 million homes in the next decade is insufficient to keep up with population growth, and Ontario would actually need a further 1.85 million homes to achieve affordability by 2030. This is partially caused by restrictive public policy and increasing costs, which disincentivizes developers, but also because construction capacity cannot keep up with demand.

Ontario attempting to ramp up construction. Over the past six years, Ontario has attempted to double its inventory of high-rise units. However, capacity has only expanded by 25 per cent, falling well short of the target. These capacity constraints are mainly caused by labour imbalances and inaccurate growth projections. Canada currently has a skilled trades labour shortage and has not developed enough people domestically or through immigration. Additionally, population and housing growth estimates were understated. In the Greater Toronto Area, population growth was underestimated by 120,000 people in 2021, and the housing stock was also lower than forecast by 26,000 units. Even with these more modest and underestimated targets, development was still unable to hit these goals, which may suggest that the long-term housing shortage situation is more severe than originally expected. This will likely cause prices to elevate further, given the anticipated future demand.

Construction Costs Have Surged



* Through June
Sources: IPA Research Services; Altus Data Solutions; Bank of Canada; Canada Mortgage and Housing Corporation; Capital Economics; CoStar Group, Inc.; Statistics Canada

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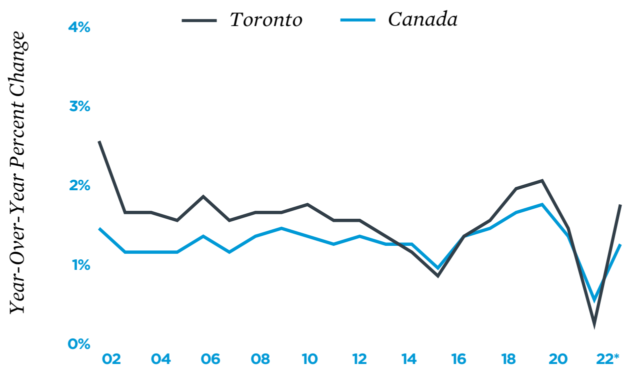
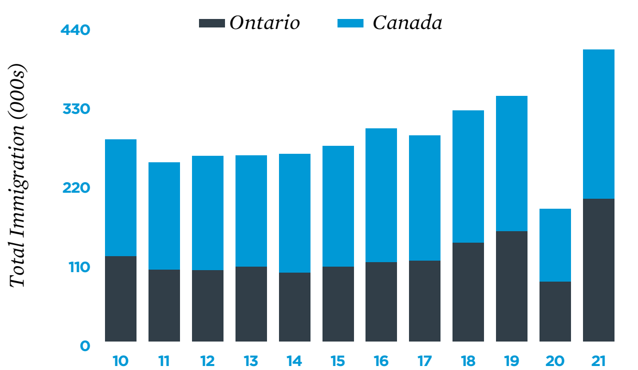
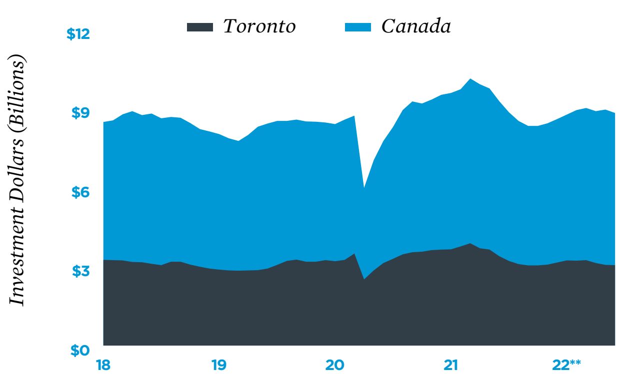
Population Growth Rebounds After Pandemic



Immigration Reaches New Heights



Residential Construction Flat-Lines



**Forecast; ** Through June, in 2012 dollars*

Demand drivers sustainable and will likely escalate. With multiple factors hindering supply, it is also expected that demand will continue to grow. This is being led by strong population growth, mostly fueled by immigration. Ontario's population grew by 200,000 residents in 2018, followed by an uptick in 2019, with 250,000 and then an additional 182,000 in 2021. Furthermore, Canada is increasing its immigration target, welcoming 450,000 permanent residents each year by 2024, with a large portion of these new residents likely coming to the Greater Toronto Area. Additionally, 38 per cent of current homeowners in Canada are immigrants, suggesting many new residents enter the country with the resources to purchase a home. Nonetheless, with supply being constricted due to rising construction costs and capacity constraints, there is limited potential for homeownership. This is due to both the lack of availability but also because of significantly elevated prices, which reinforces the importance of the apartment rental sector to help alleviate housing shortages in Ontario.

Apartment market well positioned. Historically, Toronto vacancy sits in the 1 to 2 per cent range, with annual rent growth of roughly 5 per cent. While the current supply and demand imbalance will likely continue to support strong underlying fundamentals, the elevated construction costs and capacity restrictions could reduce the amount of capital placed in future development, and instead, investors may opt for existing rentals. As of June, vacancy sits at 2.9 per cent and the average rent is $1,550 per month, a 3.6 per cent increase year-over-year. On a lease-over-lease basis, annual rent growth in Toronto sits at 10.4 per cent. With apartment demand anticipated to increase in the near future, fundamentals should continue on a favourable trajectory.

Investment activity should remain robust. The supply and demand imbalance supports a positive investment outlook for existing rentals. However, due to rising costs and limited capacity, future development may not be feasible. This makes newly-built, existing assets an attractive investment option as developments after 2018 are no longer subjected to rent control, making cost recovery and profitability more attainable. Throughout the first half of 2022, total dollar volume transacted was $1.9 billion, a 35 per cent increase from 2021, and nearly double the total dollar volume seen prior to the global health crisis in 2019. While investment activity for existing assets is robust, investment in new residential construction is falling, resulting in supply continuing to lag behind demand, hindering affordability further.

Sources: IPA Research Services; Altus Data Solutions; Bank of Canada; Canada Mortgage and Housing Corporation; Capital Economics; CoStar Group, Inc.; Statistics Canada

Prepared and edited by:

Luke Simurda
Director of Research, Canada

For information on national commercial real estate trends, contact:

John Chang
Senior Vice President, National Director
Research Services Division
Tel: (602) 707-9700 | jchang@ipammi.ca

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