HOUSING RESEARCH

Research Insight

DECEMBER 2021

Purpose-Built Rentals Facing Financial Feasibility Challenges:

Archetypical developments yield insufficient returns in selected metropolitan areas

Adequate rental supply is one of many building blocks required to achieve CMHC's 2030 aspiration—that everyone in Canada has a home that they can afford and that meets their needs. However, rental development lost ground to condominium development between the 1980s and the 2010s. The arrival of short-term rentals in recent years has also had a negative impact on the supply of rental units for local residents.

Financial considerations could be one of many explanations for the modest growth of purpose-built rentals in Canada. Traditional developers of rental units may judge that purpose-built rentals do not yield the same financial results as other types of development. To explore this idea, CMHC commissioned Altus Group Economic Consulting to assess the economics of new private-market and not-for-profit purpose-built rental development in six Canadian Census metropolitan areas (Halifax, Montréal, Toronto, Winnipeg, Calgary, Vancouver).[1] The research examines the financial performance of typical purpose-built rentals in four different scenarios and for three project archetypes. The data, assumptions, and results of this work predate the onset of the COVID-19 pandemic.

[1] This Research Insight will present only the private market results. The not-for-profit results are available in the full report https://eppdscrmssa01.blob.core.windows.net/cmhcprodcontainer/sf/project/archive/research_6/the-economics-of-purpose-built-rentals_wcover.pdf.

Canada

CMHC SCHL

About CMHC Research Insights

Research insights are summaries of our research reports.

These insights:

- identify a housing research issue, gap or need
- provide an overview of the research project undertaken to address it
- present major findings of the research

The research presented in this series explore the areas of Housing Need, Housing Finance, Housing Supply and Outcomes of the National Housing Strategy.

Sign Up

Get the latest findings directly in your inbox

SUBSCRIBE

cmhc.ca/researchnewsletter

Key Findings

The results point to financial feasibility challenges for new private rental apartment projects in the six selected markets. Land costs, government charges, and underground parking construction costs constitute some of the significant cost items hindering financial performance. Achievable market rents are also generally not high enough to support development costs in most markets.

Part of the financial feasibility challenges found by Altus Group comes from the discrepancy between achievable (i.e. market) and required (i.e. economic) rents in all the markets examined. Economic rent is the rent required to obtain a cash-on-cash return of 10% over 10 years.[2] Table 1 illustrates this difference.

[2] The next section of this report presents the definitions of the different financial performance indicators, the project types, and the scenarios studied.

Table 1: Market rents are below economic rents in almost every case[3]

City	Basic Project (incl. land costs)			Mid-End Project (incl. land costs)			High-End Project (incl. land costs)		
	Market Rent	Economic Rent	Difference	Market Rent	Economic Rent	Difference	Market Rent	Economic Rent	Difference
Vancouver	$1,725	$2,316	**-$591**	$1,920	$2,965	**-$1,045**	$2,310	$3,967	**-$1,657**
Calgary	$1,387	$1,235	$152	$1,505	$1,849	**-$344**	$1,768	$2,293	**-$525**
Winnipeg	$1,356	$1,478	**-$122**	$1,610	$2,036	**-$426**	$1,686	$1,860	**-$174**
Toronto	$2,250	$2,502	**-$252**	$2,346	$3,237	**-$891**	$2,680	$4,002	**-$1,322**
Montréal	$1,125	$1,502	**-$377**	$1,420	$1,905	**-$485**	$1,830	$2,275	**-$445**
Halifax	$1,485	$2,007	**-$522**	$1,920	$2,529	**-$609**	$2,379	$2,621	**-$242**

Source: Altus Group Economic Consulting

That said, the feasibility of rental apartment development is project- and size-specific. As such, we should not conclude that no development will take place given the financial challenges. In fact, there has been a recent uptick in activity and interest for purpose-built rental apartment construction, suggesting that developers are making rental development work. Some developers may find rental development attractive under various circumstances. For example if they:

- Acquired land years earlier and are now willing to develop it.
- Have access to government incentive programs, such as CMHC's Rental Construction Financing initiative.
- Have an underutilized site or excess land that can be intensified.
- Use different development criteria than the indicators reviewed in this work (e.g., real estate investment trusts may assess feasibility differently than more traditional developers).

Altus Group used proprietary data, CMHC data, and professional assumptions and judgements to estimate the financial performance indicators. While this work is an update of similar work conducted by Altus Group in 2016, comparisons are not always possible, given methodology and data changes. All the details are available in the full report.[4]

[3] Rent assumptions reflect market conditions in early 2020.
[4] https://eppdscrmssa01.blob.core.windows.net/cmhcprodcontainer/sf/project/archive/research_6/the-economics-of-purpose-built-rentals_wcover.pdf

Variables and Scenarios

Performance Indicators

Altus Group's work focused on estimating **four financial performance indicators** for new purpose-built rentals:

- **Cash-on-cash return (including principal payment):** This metric is a direct way to measure returns from rental operations and takes into account the reduction in loan principal every year. This metric divides the annual cash flow (including principal payments) of a project by its equity requirement. The average annual (cumulative) results provide the average return of a given year and all the preceding years. **A typical target return is 10%.**
- **Internal rate of return (levered, 10 years):** This metric allows developers to compare investment options of different scales and characteristics (real estate or non-real estate). This rate of return equates the discounted value of the net cash flows and the residual equity (i.e. the net present value) to the initial equity investment. A higher internal rate of return indicates a more attractive investment option.
- **Margin on cost:** This is the profit margin of a project. This metric is based on the estimated project value and on total development costs. We use the expected net operating income upon stabilized occupancy and capitalization rate (assumed to occur on the third year of operations) to estimate the project value. **Generally, a margin of 15% is required for financing purposes.**
- **Yield on cost (return on cost):** Developers can use this metric in comparison to the capitalization rate (net income divided by market value) for an acquisition program. It compares the options of buying or building rental units. We obtain this metric by dividing net operating income by total development costs.

While these are common financial performance indicators, they do not represent an exhaustive list. Developers might also use different criteria when deciding to pursue a project.

Project Types

Altus Group's research estimated the financial performance indicators **for three different types of projects:**[5]

- **Basic project:** a low-rise building of 50 units, in a fringe location of the market, with basic-quality finishes.
- **Mid-end project:** a mid-rise building of 100 units, located centrally but not downtown, with medium-quality finishes.
- **High-end project:** a high-rise building of 150 units, located downtown but not in a prime location, with high-quality finishes.

These project types are illustrative of the range of project characteristics that might occur in a market area, but they are not exhaustive in terms of the possibilities. In reality, site-specific conditions and many other considerations that are not included in this analysis dictate project characteristics.

Scenarios

Altus Group estimated the financial performance indicators for each type of project in four different scenarios:

- **Scenario 1:** achievable market rents and market land costs.
- **Scenario 2:** achievable market rents and zero land costs.
- **Scenario 3:** required rent to make project financially viable (economic rent) and market land costs.
- **Scenario 4:** required rent to make project financially viable (economic rent) and no land costs.

This Research Insight only presents the results for Scenario 1. The results for the other scenarios are available in the full report.[6] All scenarios assume a CMHC-insured loan with an 85% loan-to-cost ratio, 40-year amortization, and 2.75% interest rate.

[5] Altus Group assumed an average suite mix for each type of project. Altus' assumptions reflect CMHC's primary rental market universe data on apartment units built in 2000 or later in each of downtown, central and fringe locations. Altus Group generally keeps suite size assumptions consistent throughout markets, except for Halifax and Winnipeg, where average suite sizes tend to be relatively large.

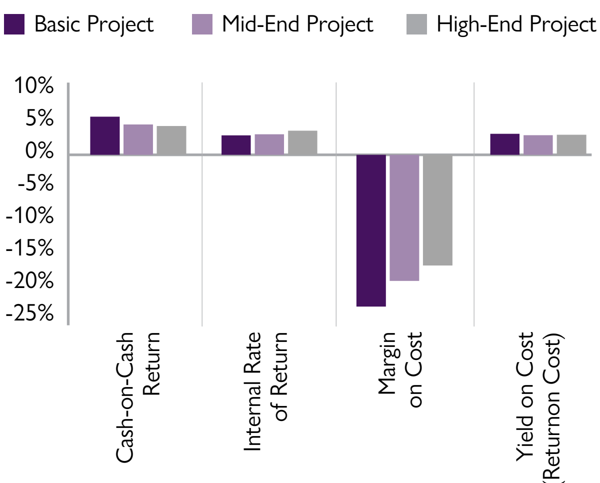
[6] https://eppdscrmssa01.blob.core.windows.net/cmhcprodcontainer/sf/project/archive/research_6/the-economics-of-purpose-built-rentals_wcover.pdf

Highlights By Market

Vancouver

- In Vancouver, it is more financially attractive to purchase rentals than to develop them. Indeed, the capitalization rates (net income divided by market value) are higher than the yield on cost (net income divided by development costs) for all project types.
- Vancouver has the highest development costs of all markets studied (with and without land costs).
- The cost of land heavily impacts the return on investment. Rents in Vancouver would need to be roughly 35% to 70% higher than they currently are to achieve a 10-year cash-on-cash average return of 10%.
- However, rental starts have been on the rise in Vancouver since 2014 (and a low vacancy rate suggests that the market has been able to absorb this new supply). This increase in supply suggests that developers are making rental projects work.
- Figure 1 shows the overall results for Vancouver under Scenario 1 (market rents and land costs). Note that the typical target for cash-on-cash return is 10%. Generally, the required margin on cost is 15%.

Figure 1: Financial indicators do not support rental development in Vancouver

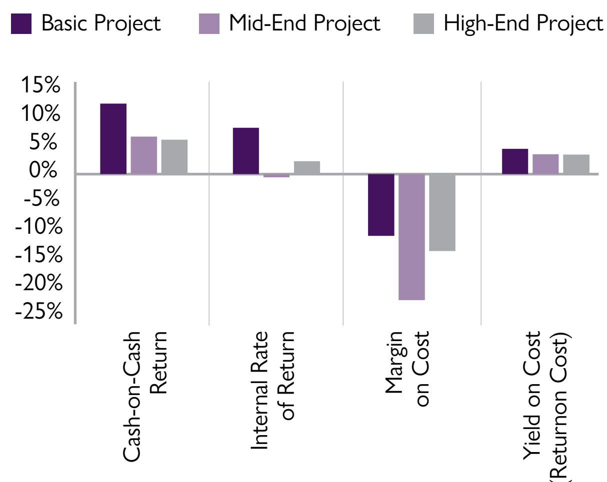


Source: Altus Group Economic Consulting

Calgary

- In Calgary, purchasing rentals is financially more attractive than developing them. Indeed, the capitalization rates are higher than the yield on cost for all project types.
- Rents would need to be 25% to 30% higher for the mid- and high-end projects to achieve a 10-year cash-on cash average return of 10%.
- However, Calgary saw higher levels of starts in 2017-19 than the average over the previous 20 years. Calgary also has the highest vacancy rate among the markets reviewed (5.5%). The low cost of land could explain the increase in supply despite the higher vacancy rate.
- Figure 2 shows the overall results for Calgary under Scenario 1 (market rents and land costs). Note that the typical target for cash-on-cash return is 10%. Generally, the required margin on cost is 15%.

Figure 2: Typical basic projects in Calgary could be financially attractive

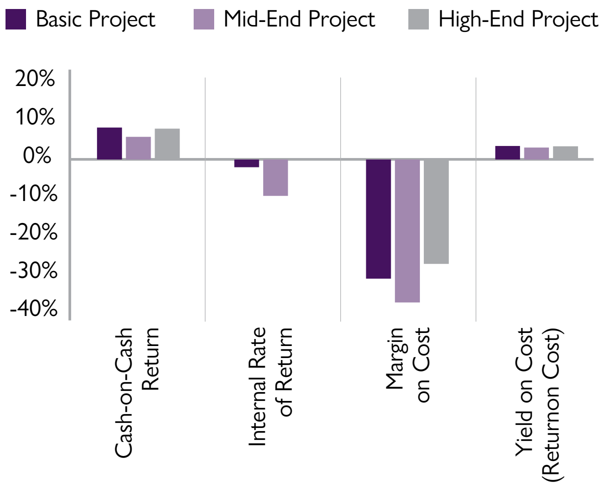


Source: Altus Group Economic Consulting

Winnipeg

- In Winnipeg, capitalization rates are higher than yields on cost, meaning that it is financially preferable to purchase purpose-built rentals than to develop them.
- The cost of a high-end project in Winnipeg is the lowest among the six markets studied. This is largely due to the lower cost of land in downtown Winnipeg. However, the low cost to develop does not offset low rents.
- That said, the development of apartment rental units accelerated in 2015-19. In fact, developers started roughly the same number of units between 1999 and 2014 as they did between 2015 and 2019 (around 7,500 units). This indicates that developers are making rental development work.
- Figure 3 shows the overall results for Winnipeg under Scenario 1 (market rents and land costs). Note that the typical target for cash-on-cash return is 10%. Generally, the required margin on cost is 15%.

Figure 3: Financial indicators do not support rental development in Winnipeg

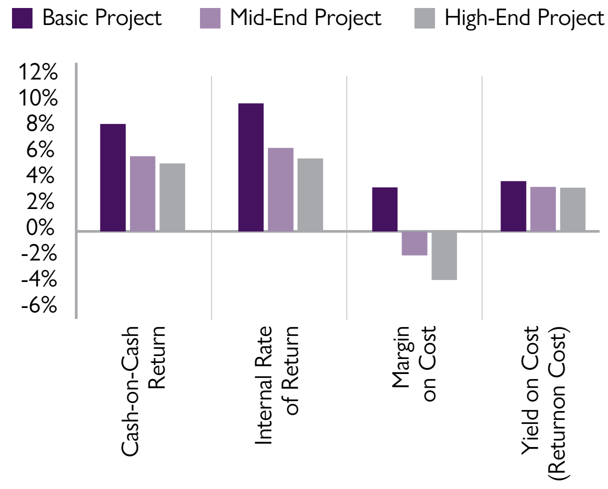


Source: Altus Group Economic Consulting

Toronto

- In Toronto, it is preferable to develop mid- and high-end projects than to purchase them, since capitalization rates are lower than yield on cost.
- However, rents would need to be 10% (basic project) to 50% (high-end project) higher for projects to achieve a 10-year cash-on cash average return of 10%.
- Given the cost of land in Toronto, taking land out of the analysis does significantly improve financial performance and makes some of the project types look more viable.
- Still, developers started some 4,000 units in Toronto in 2019, the largest number over the 1999–2019 period. This was well above the five-year average of 2,986 units. Starts in 2020 had surpassed the 2019 numbers by September.
- Figure 4 shows the results for Toronto under Scenario 1 (market rents and land costs). Note that the typical target for cash-on-cash return is 10%. Generally, the required margin on cost is 15%.

Figure 4: It is more attractive to build a basic development than to purchase one in Toronto (yield on cost)



Source: Altus Group Economic Consulting

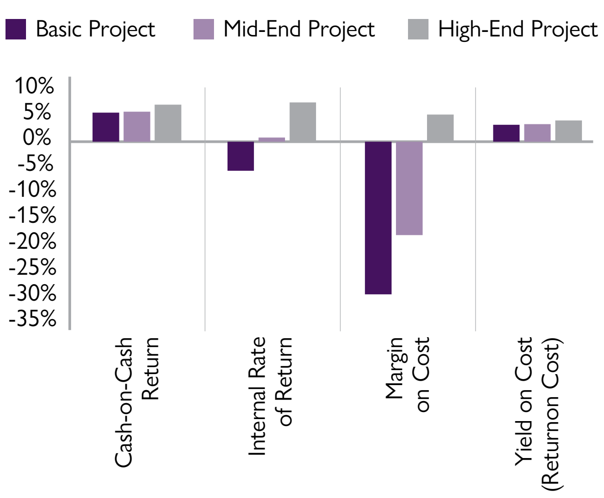
Montréal

- In Montréal, it is financially preferable to develop high-end projects than to purchase them, since the yield on cost is higher than the capitalization rate.
- The high-end project type in Montréal also exhibits a better margin on cost and a better internal rate of return than in the other markets. On the other hand, Montréal's basic project has the lowest internal rate of return of all markets.
- Rents would still have to be 30% to 35% higher for the basic and mid-end projects—and 25% higher for the high-end project—to achieve a 10-year cash-on-cash average return of 10%.
- That said, rental starts increased significantly in Montréal between 2015 and 2019. In particular, developers started over 9,000 units in 2017-19.
- Figure 5 shows the results for Montréal under Scenario 1 (market rents and land costs). Note that the typical target for cash-on-cash return is 10%. Generally, the required margin on cost is 15%.

Halifax

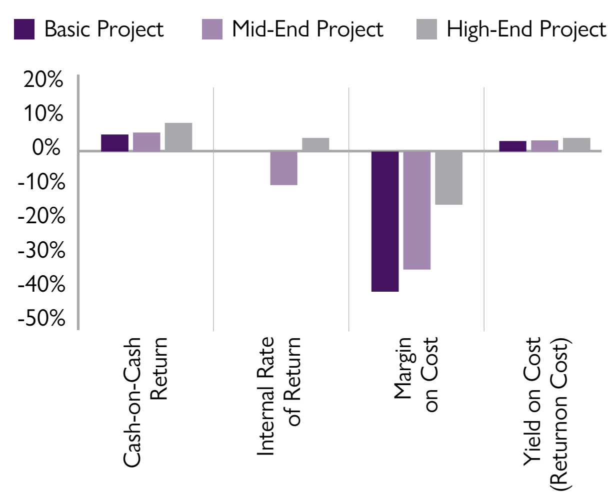
- Halifax exhibits higher capitalization rates than yield on cost for all project types. It is thus financially preferable to purchase rentals than to develop them.
- The margin on cost for the basic project is the poorest of the six markets, at -41.0%. The same measure for a mid-end project is -34.5%, and -15.6% for a high-end project. The margin on cost remains negative even with the removal of land costs.
- Rents would need to be roughly 30% to 35% higher for a basic or mid-end project and 10% higher for a high-end project to achieve a 10-year cash-on-cash average return of 10%.
- Still, Halifax developers started 2,058 units in 2019, the highest number of starts since 1999.
- Figure 6 shows the results for Halifax under Scenario 1 (market rents and land costs). Note that the typical target for cash-on-cash return is 10%. Generally, the required margin on cost is 15%.

Figure 5: It is more attractive to build a high-end development than to purchase one in Montréal (yield on cost)



Source: Altus Group Economic Consulting

Figure 6: Financial indicators do not support rental development in Halifax



Source: Altus Group Economic Consulting

Implications

- Traditional financial performance indicators do not support the development of private-market, purpose-built rentals in the six Canadian markets studied. This suggests that developers are using other criteria, or that non-traditional developers (such as REITs and pension funds) are driving growth.
- Previous exploratory research points in the same direction concerning the interest of non-traditional developers in purpose-built rentals.[7]
- The full report shows that land costs remain a prohibitive cost to financial performance. Without land costs, Toronto would offer consistently positive financial results across project types and across financial indicators.
- Market rents are consistently below economic rents (i.e. rents required to make a project financially viable). In other words, market rents are rarely sufficient to cover the development and construction costs of projects, regardless of the project size, location, and quality of the finishes.

Full Report

Purpose-Built Rentals Facing Financial Feasibility Challenges: Archetypical developments yield insufficient returns in selected metropolitan areas, 2021

https://eppdscrmssa01.blob.core.windows.net/cmhcprodcontainer/sf/project/archive/research_6/the-economics-of-purpose-built-rentals_wcover.pdf

Project Manager

Henry Diaz
Housing Research
Canada Mortgage and Housing Corporation

Consultant

Altus Group Economic Consulting

[7] Prism Economics. Constraints on the Supply of New Purpose-Built Rental Projects. https://eppdscrmssa01.blob.core.windows.net/cmhcprodcontainer/sf/project/archive/publications_2/20200717-003_rr_supply_constraints_en_jul23.pdf

CMHC helps Canadians meet their housing needs

Canada Mortgage and Housing Corporation (CMHC) has been helping Canadians meet their housing needs for more than 70 years. As Canada's authority on housing, we contribute to the stability of the housing market and financial system, provide support for Canadians in housing need, and offer unbiased housing research and advice to Canadian governments, consumers and the housing industry. Prudent risk management, strong corporate governance and transparency are cornerstones of our operations.

For more information, visit our website **cmhc.ca** or follow us on Twitter, LinkedIn, Facebook, Instagram and YouTube.

You can also reach us by phone at 1-800-668-2642 or by fax at **1-800-245-9274**.

Outside Canada call **613-748-2003** or fax to **613-748-2016**.

Canada Mortgage and Housing Corporation supports the Government of Canada policy on access to information for people with disabilities. If you wish to obtain this publication in alternative formats, call **1-800-668-2642**.

69820 20211103-001A

Alternative text and data for figures

Figure 1: Financial indicators do not support rental development in Vancouver

	Basic Project	Mid-End Project	High-End Project
Cash-on-Cash Return	5.9%	4.7%	4.5%
Internal Rate of Return	3.0%	3.2%	3.7%
Margin on Cost	-23.4%	-19.4%	-17.0%
Yield on Cost (Return on Cost)	3.3%	3.0%	3.1%

Source: Altus Group Economic Consulting

Figure 2: Typical basic projects in Calgary could be financially attractive

	Basic Project	Mid-End Project	High-End Project
Cash-on-Cash Return	12.4%	6.6%	6.1%
Internal Rate of Return	8.2%	-0.6%	2.3%
Margin on Cost	-10.9%	-22.3%	-13.6%
Yield on Cost (Return on Cost)	4.5%	3.5%	3.5%

Source: Altus Group Economic Consulting

Figure 3: Financial indicators do not support rental development in Winnipeg

	Basic Project	Mid-End Project	High-End Project
Cash-on-Cash Return	8.3%	5.9%	8.1%
Internal Rate of Return	-2.0%	-9.5%	0.1%
Margin on Cost	-31.1%	-37.3%	-27.2%
Yield on Cost (Return on Cost)	3.5%	3.1%	3.5%

Source: Altus Group Economic Consulting

Figure 4: It is more attractive to build a basic development than to purchase one in Toronto (yield on cost)

	Basic Project	Mid-End Project	High-End Project
Cash-on-Cash Return	8.3%	5.8%	5.2%
Internal Rate of Return	9.9%	6.4%	5.6%
Margin on Cost	3.4%	-1.9%	-3.8%
Yield on Cost (Return on Cost)	3.9%	3.4%	3.4%

Source: Altus Group Economic Consulting

Figure 5: It is more attractive to build a high-end development than to purchase one in Montréal (yield on cost)

	Basic Project	Mid-End Project	High-End Project
Cash-on-Cash Return	5.6%	5.8%	7.1%
Internal Rate of Return	-5.6%	0.8%	7.6%
Margin on Cost	-29.5%	-18.1%	5.2%
Yield on Cost (Return on Cost)	3.3%	3.4%	4.1%

Source: Altus Group Economic Consulting

Figure 6: Financial indicators do not support rental development in Halifax

	Basic Project	Mid-End Project	High-End Project
Cash-on-Cash Return	5.0%	5.6%	8.4%
Internal Rate of Return	n.a.	-9.8%	4.0%
Margin on Cost	-41.0%	-34.5%	-15.6%
Yield on Cost (Return on Cost)	3.1%	3.3%	4.0%

Source: Altus Group Economic Consulting