

HOUSING MARKET INSIGHT

Greater Toronto Area



CANADA MORTGAGE AND HOUSING CORPORATION

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"Condo building activity in Toronto seems to be well managed. In spite of this encouraging information, future inventory management will be critical."



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Risks mitigated in condo building in Toronto

Highlights

- Majority of condominium apartment projects (79 per cent) started construction after reaching a pre-construction sales threshold of 70 per cent
- Projects that started construction significantly below the 70 per cent sales threshold are mainly smaller in size or a subsequent phase of a larger development
- Current unsold inventory is largely concentrated within Toronto Centre and Markham where condominium markets are more active
- Projects that currently have a high level of unsold inventory started construction prior to reaching a sales threshold of 70 per cent

Background

The housing bubble that occurred in Toronto in the late 1980s was arguably fuelled by huge speculative investment in the condominium apartment market. Rapid house price growth in the late 80s transformed real estate investment. More buyers entered the market hoping to make quick profits triggering an artificial increase in demand. Subsequently fewer homes became available for sale, leading to further price growth. In response, developers provided more supply by building condominium apartments (hereafter referred to as condos), many of them in downtown Toronto. Anecdotal evidence suggests that many of these projects started construction with low pre-construction sales thresholds (partly in order to speed up construction and developers wagering on guaranteed sales at the point of completion). As the economy turned and demand for housing softened, there were fewer buyers for these units that were now abundant in the market. The ensuing result was falling prices and an 'exodus' from the condo market.

Today, high rise buildings have become a defining feature of the Toronto skyline. However, concerns about condo overbuilding continue to persist. Overbuilding is a key indicator of market stability in CMHC's Housing Market Assessment (HMA) Framework. Condos account for about 50 per cent of residential construction in the Toronto Census Metropolitan Area (hereafter referred to as Toronto). In Q1 2016, 43,860 units were under construction across Toronto and 1,373 units were completed and unsold.

To complement our HMA Framework, CMHC undertook research to assess whether high-rise builders were starting and completing projects with high levels of unsold units. We looked at the threshold of pre-construction sales (hereafter referred to as sales threshold) a project would reach before commencing construction¹. Lenders typically insist on a 60-80 per cent sales threshold target prior to commencing construction in order to provide construction financing. For the purpose of this report, we examined the characteristics of any project that started construction before reaching a 70 per cent sales threshold.

This report also focuses on Toronto's current stock of completed and unsold condos (hereafter referred to as inventory) and their association to any speculative building activity. Ultimately, as inventories rise, the risks of softening prices can spread from being just a builder specific risk to a wider market risk affecting all builders and homeowners.

Results

Condo Building Practices

Finding 1: Higher sales prior to start

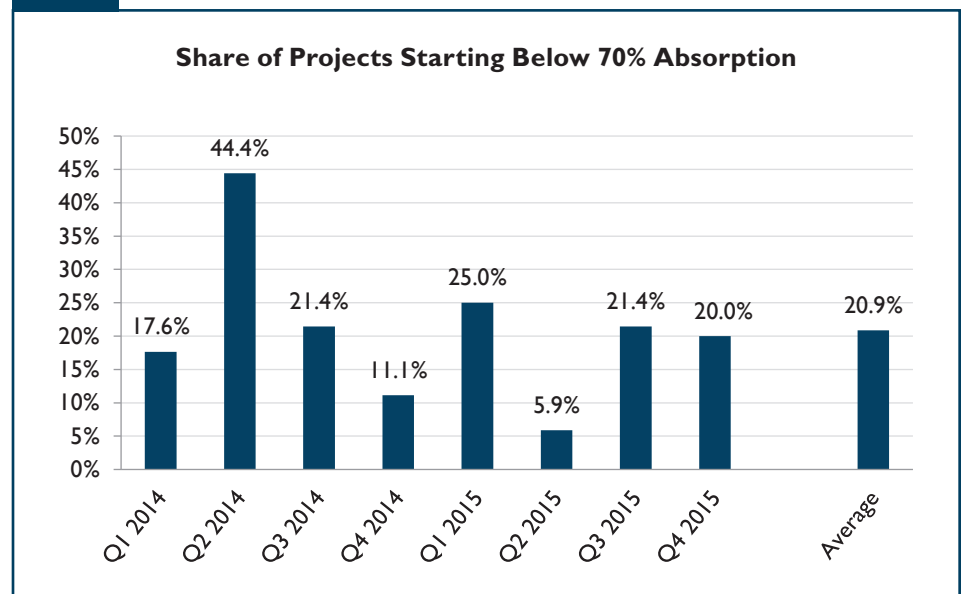
Out of the total projects that began construction during the sample period (Q1 2014 to Q4 2015), 79 per cent started after reaching a sales threshold of 70 per cent. This high number is in line with a more conservative underwriting approach adopted by most lenders in the past decade. The findings apply equally to projects located in the 416 and 905 area codes.

Over this sample period, an average of 21 per cent of the projects (see Figure 1) started construction prior to reaching the 70 per cent sales threshold. The majority of incidents when construction started at significantly lower absorption² rates fell under the following categories:

- Relatively smaller projects with less than 100 units.

- Large-scale reputable developers, which either had several construction projects going at once, or which built many condos in the past and therefore were capable of injecting more equity into the project. In some rare instances, some of these developers were able to start construction even without preselling.
- Multi-phase projects, which reached a high or full absorption in their early phases (usually first phase), had enough equity for the next phase to commence construction without reaching the 70 per cent sales threshold. These multi-phase projects would be linked to each other via a bridge, share common foundations or be located within close proximity to each other, and therefore made logistical sense to start simultaneous construction.

Figure 1



Source: CMHC Starts & Completions Survey and Market Absorption Survey and calculations using sales data from Altus Group and Urbanation Inc..

The results for the second quarter of 2014 were atypical, in the sense that nearly half (44 per cent) of all projects during that period started construction without reaching the 70 per cent sales threshold. During this time there was an unusually high number of multi-phase projects, which brought down the average absorption rate at start to 68 per cent, while the average absorption rate for the sample period was 80 per cent (see Figure 2).

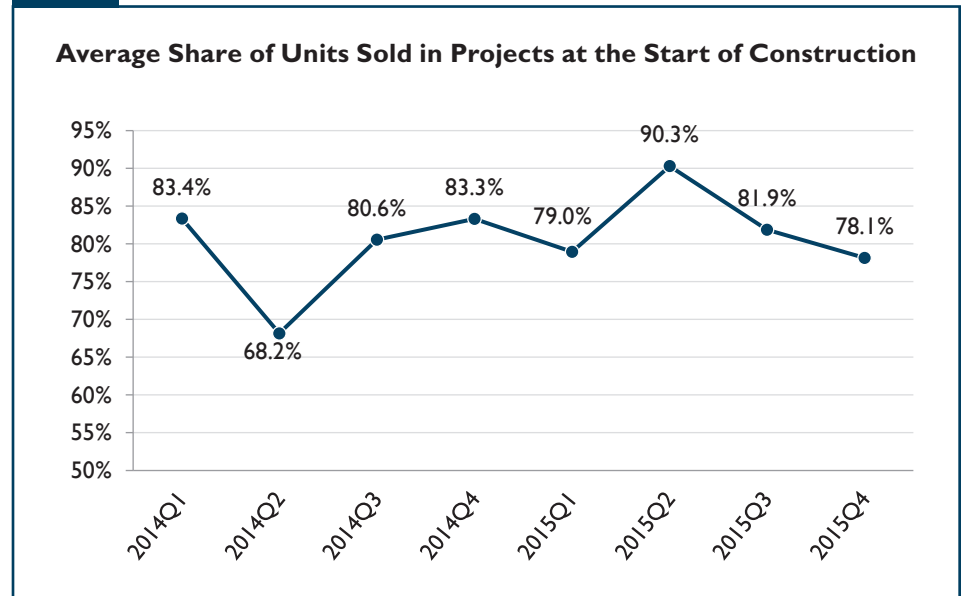
Finding 2: Projects with higher sales thresholds take longer to start construction

Over the sample period, the average duration of a project was around 27 months between a sales centre opening and its start of construction. However, the duration of the pre-construction phase varied significantly among projects, depending on their levels of sales. Projects that achieved sales above 70 per cent took on average 29 months to start construction while projects with sales below 70 per cent started within an average of 21 months. It appears that builders and developers were not rushing their decisions to commence projects although their decisions to commence projects were undoubtedly influenced by municipal approval and permit processes, the marketing plan of the project, the number of phases and developers' commitment to meet a certain occupancy schedule.

Inventory of Condos

When projects commence construction without reaching higher sales thresholds (close to 70 per cent) higher inventories can result, especially if those units are still unsold at completion. As inventories rise, the risks related to softening prices can spread from being just

Figure 2



Source: CMHC Starts & Completions Survey and Market Absorption Survey and calculations using sales data from Altus Group and Urbanation Inc..

a builder specific risk to a wider market risk affecting all builders and homeowners.

In order to investigate any discerning trends in inventory, we also examined the stock of completed and unsold (i.e. not fully absorbed at 100 per cent) condos over the sample period and into Q1 2016. At the end of Q1 2016, inventory stood at 1,373 units.

Finding 3: Current³ inventory is concentrated within a small number of projects

Approximately 40 per cent of the inventory was concentrated among only 10 per cent of the projects within the total universe of completed and unabsorbed projects in Q1 2016 (76 projects). Within these projects, the average share of inventory was 18 per cent. The remaining 90 per cent of projects (which were spread out across Toronto) had an average share of unabsorbed units at four per cent.

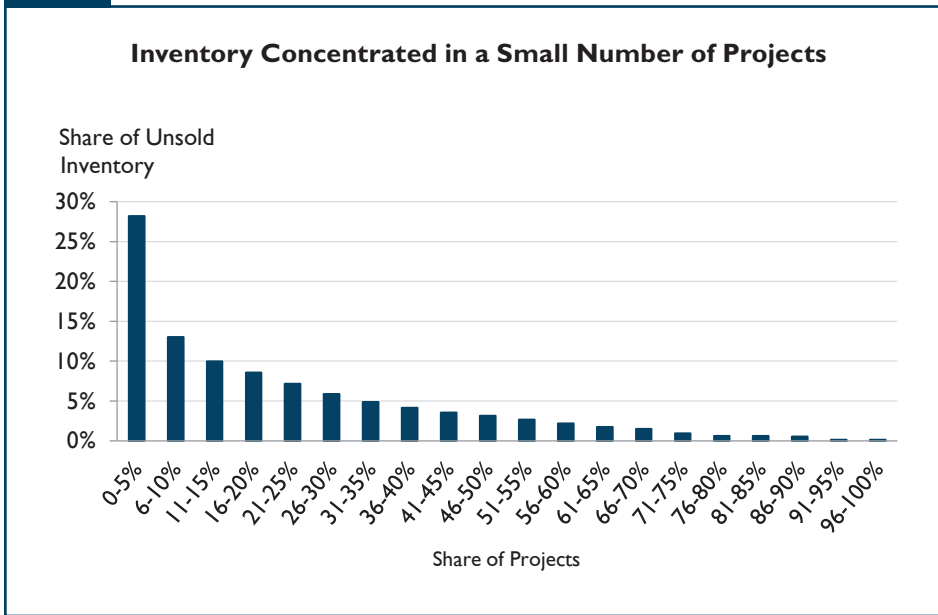
Finding 4: Higher concentration of inventory within Toronto Centre

The highest concentration of inventory was found in the Yonge & Bloor area, CityPlace and just west of downtown in the King West/Liberty Village areas, followed by some concentration in mid-town near Davisville (see Figure 4). Etobicoke and North York had a more modest share of unsold units. In the 905 areas, inventory was most pronounced in Markham, where the expansion of Highway 7 had induced rapid growth in condo developments over the past eight years.

Finding 5: Projects with higher inventory had lower sales at start of construction

Projects with a higher proportion of inventory (greater than 10 per cent) sold on average 59 per cent of units at the start of construction, which was well below the industry average sales threshold of 70 per cent. Nearly 50 per cent of these projects had less than half of their units sold upon start of construction.

Figure 3



Source: CMHC Market Absorption Survey, Q1 2016.

Finding 6: Average absorption rate remained stable

By the end of 2015 the number of condo completions as well as inventory doubled compared to 2014. Nevertheless, the average absorption rate in Toronto remained virtually unchanged at around 94 per cent. During this time, the average project size also grew to 280 units in Q1 2016 compared to 205 units in Q1 2014. Larger projects (300 or more units) are slowly outpacing smaller projects and currently account for 70 per cent of the universe⁴ compared to 50 per cent throughout 2014. A large share of smaller projects (less than 75 units) were stacked townhomes, which CMHC counts as apartments in its Starts and Completions Survey. The nature of this dwelling/project type (in terms of infrastructure requirements) allowed or compelled developers to start construction without preselling the vast majority of their units.

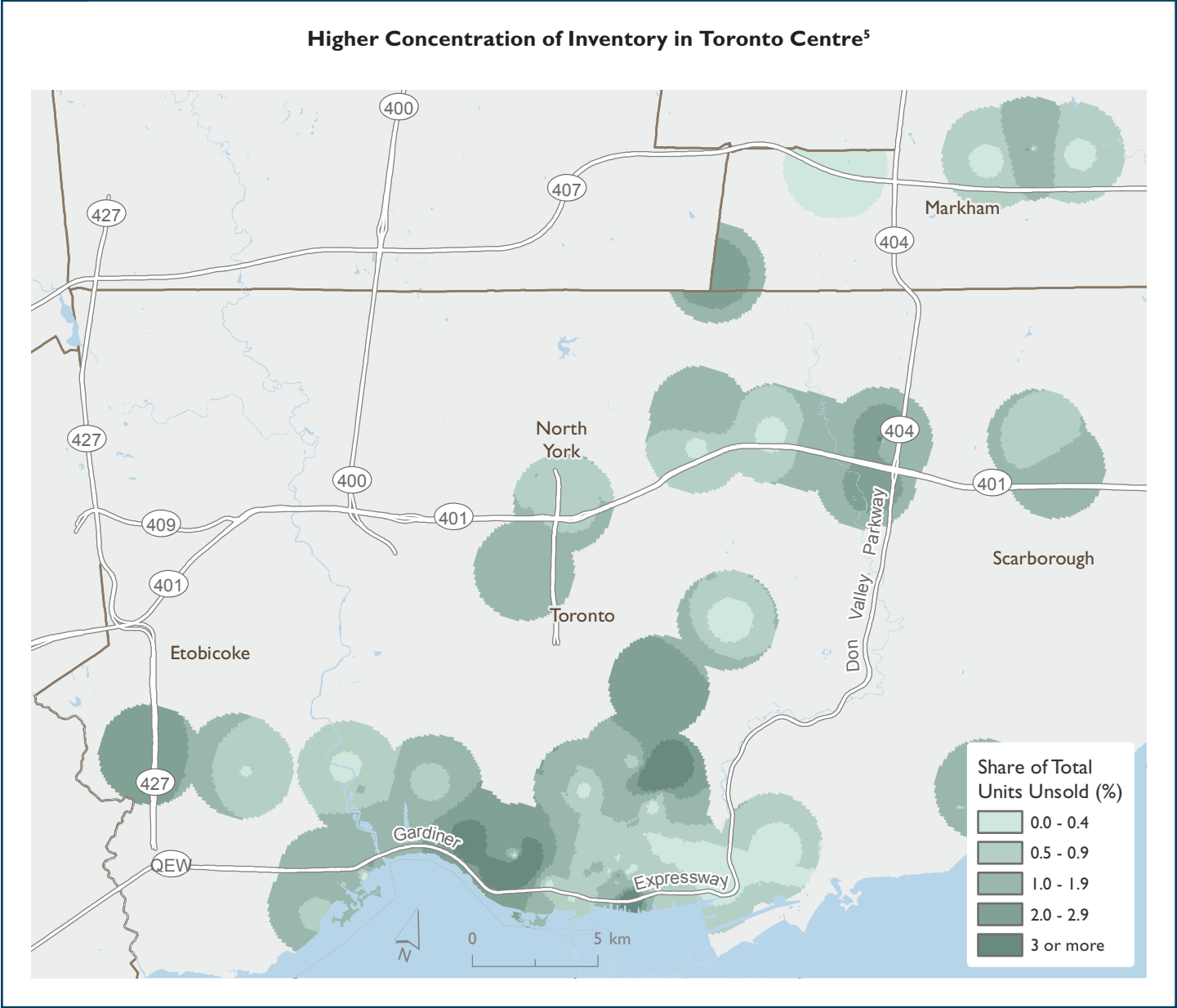
Implications

In general, our research shows that the majority of builders wait until a higher sales threshold is reached prior to commencing construction thus mitigating risks associated with speculative building. A tight resale condo market and strong rental demand have helped to absorb some of the completed and unsold units. The current inventory level is low compared to the highs witnessed during the early 1990s and has eased from a slight increase in 2015. Inventory is also mainly concentrated among fewer projects and not broadly based among a number of projects. However, projects that currently have higher inventories appear to have engaged in some speculative building activity as indicated by their lower sales thresholds prior to commencing construction. The rate of full absorption is also subject to individual marketing efforts and the location of buildings

in relation to competing projects – aspects this study did not probe in order to protect the confidentiality of projects. By definition, any unit started but not sold is built on speculation. Builders must balance the trade-off between minimizing speculative building (selling every unit before construction) and making units available for buyers looking to move-in straight away. If builders were to sell every unit before starting construction, then buyers who bought at project initiation may have to wait a long time (five years or more) to occupy their units. Also the rental market (both primary and secondary) could experience supply shortages due to increased demand from buyers looking for interim accommodation while waiting to occupy their units. This can put undue upward pressure on rents and prices and de-stabilize the housing market. On the other hand, with too low a sales threshold, there is a greater risk of an oversupplied market. Inventory management therefore continues to be necessary to make sure that condominium units currently under construction do not remain unsold upon completion.

This study is also limited to analysis based on current conditions and is not indicative of any particular future behaviour. While condo building activity seems to be well managed in Toronto, this study does not address the likelihood of speculative buying from individual investors. The Condominium Owners Survey for Toronto & Vancouver released earlier this year addressed this aforementioned issue and found that more investors were holding on to their investment properties for 5 or more years and the likelihood of flipping their properties was lower.

Figure 4



Source: CMHC Market Absorption Survey, Q1 2016.

Reference Table Condominium Apartment Unit Status, Toronto CMA				
	Flow	Stock		
Quarter	Share of unabsorbed of newly completed	Universe*	Unabsorbed units	Share of unabsorbed
Q1 2014	0.0%	13,074	852	6.5%
Q2 2014	5.2%	15,196	1,122	7.4%
Q3 2014	2.1%	15,597	952	6.1%
Q4 2014	2.1%	15,662	917	5.9%
Q1 2015	7.3%	24,711	1,871	7.6%
Q2 2015	14.0%	28,181	1,956	6.9%
Q3 2015	6.0%	28,224	1,865	6.6%
Q4 2015	3.2%	30,294	1,966	6.5%
Q1 2016	5.9%	23,876	1,373	5.8%

* Total number of units in completed projects without 100% absorption

Source: CMHC Starts and Completions and Market Absorption Surveys

ENDNOTES

- ¹ Each condo project that was started between Q1 2014 and Q4 2015 was matched with its individual sales threshold pertaining to the exact time it began construction. Record level data of projects using data from CMHC Starts & Completions Survey, Altus Group & Urbanation Inc. were used.
- ² The term “absorbed” means that a housing unit is no longer on the market (i.e. has been sold or rented). This usually happens when a binding contract is secured by a non-refundable deposit and has been signed by a qualified purchaser.
- ³ Current reference is to data for Q1 2016.
- ⁴ Total number of completed but not fully absorbed.
- ⁵ The values presented on the map should not be interpreted to represent an exact measurement of the entire shaded locations. They should rather serve as a general indication regarding the observed phenomenon in each space. This map was created by averaging the values of known sample data points. The closer the data points are to each other, the more influence or weight it has in the averaging process. The coloured surfaces produced from the source data were subsequently limited to a radius of 2 km from the actual data points in order to maintain privacy and confidentiality.

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