THE GLOBE AND MAIL

February 25, 2019

Cracks appear in Toronto's new-build condo craze as the investor-supported frenzy fizzles

JANET MCFARLANDREAL ESTATE REPORTER

The Toronto lakeshore is photographed on Jan. 31, 2019.

CHRISTOPHER KATSAROV/THE GLOBE AND MAIL

Trevor Nicolle didn't line up outside in 2018.

The Toronto-based real estate agent, who specializes in new-build condominiums at Royal LePage Signature Realty, joined the queues outside sales centres in 2017, when lines stretched far down the street before the launch of a new project. He even pitched a tent on the sidewalk with some colleagues and slept outside one winter night to get first dibs on units for his clients.

As the boom continued, he started paying people to wait overnight for him, showing up to take his place in line just before the doors opened.

But things changed last year, when more projects were launched and more options were available. Suddenly, clients had three or four projects to consider. They could actually take a day to think about a purchase – without finding the price was $10,000 higher on the second day of sales. And agents such as

Mr. Nicolle, who were "doing cartwheels" in 2017 if they could secure any units for their clients in a new development, were gradually being allocated more and more units in new projects.

Demand has remained strong, but "it's more normalized," Mr. Nicolle says. "I don't look at that in a negative way."

From a distance, Toronto's preconstruction condominium market has looked like the last remaining bubble in the city's overheated real estate market, with prices hitting a record high in 2018 and the average unit selling for more than $1,000 a square foot in central Toronto, according to industry data-tracking firm Urbanation Inc.

Even across the Greater Toronto Area, which includes vast suburbs, the price of a preconstruction condo climbed 56 per cent over the past two years to a record $921 a square foot, says Urbanation, which estimates the average unit sold for $625,000 in 2018.

But on the ground, there are signs the new-construction market is cooling and sales are moving back down to more normal levels. The number of preconstruction condo units sold in the GTA fell 42 per cent in 2018 from the previous, peak year, as demand for new projects slowed and long lineups virtually disappeared at sales centres.

Trevor C. Nicolle, realtor and broker poses for a photograph at the Lakeside condo development presentation centre in Toronto.

CHRISTOPHER KATSAROV/THE GLOBE AND MAIL

One big reason has been growing cautiousness among investors – those buyers who intend to flip or rent out their units. They have been key to the new-build market, buying about half the units sold in the Toronto area in recent years – and creating the largest supply of rental units in the city.

Rental price growth fuels the investor market, but the math is not working as well these days: Interest-rate increases and rising sale prices have left costs outstripping rents, with owners having trouble covering their monthly expenses and facing lower potential profits.

Depending how far it goes, a pullback by investors could have a major impact on Toronto's construction industry, which is currently working flat out to build almost 70,000 units in 237 buildings in the GTA.

Many are now watching Vancouver, where sales of preconstruction condo units fell 15 per cent in the first nine months of 2018 and average sale prices slid almost 15 per cent between the first and third quarters as investor activity cooled, according to data firm Altus Group.

Toronto may not follow the same pattern, and many builders say new-construction sales are simply stabilizing at a historically normal level after an unnatural frenzy in 2017.

But some analysts fear a more significant hit could be coming as a flood of new supply comes on the market, potentially easing the city's ultralow vacancy rate and limiting rent increases for investors.

"I think those days of the modern gold rush in Toronto, where every developer was selling out within 30 days, are gone," said real estate agent Adam Brind of Core Assets Real Estate in downtown Toronto. "I think everyone has to work a little harder now. You can't just throw up a sign and say, 'We're launching this,' and have a huge lineup."

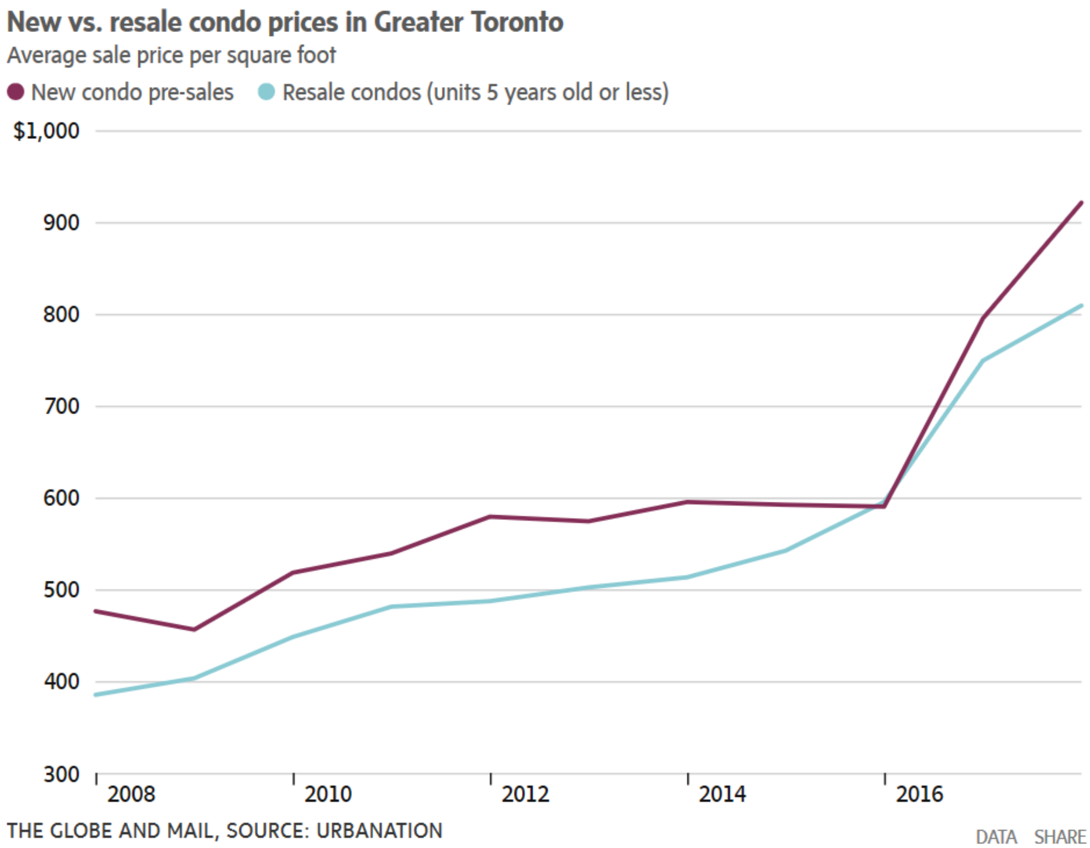
Toronto's condominium market launched into overdrive in 2016 as the city's housing sector soared into bubble territory.

Many investors jumped into the prebuild sector in 2016 and 2017 as they watched others make huge profits on units purchased years before.

Even as the GTA's low-rise housing boom started to fade in mid-2017 after governments introduced measures to cool the market – including a new foreign-buyer's tax and tougher new federal mortgage qualification rules – buyers seeking relative affordability turned to the condo sector, driving sales of preconstruction units to a record high of almost 34,697 in 2017, a 28-per-cent increase over 2016.

In 2018, however, even the condo sector began to feel the strain. The sales volumes of both resale and prebuild condos fell from the previous year's highs. Prices continued to rise due to tight inventories, but the pace of the price increases began to slow, especially for resale condos.

As the year progressed, prices for new-build condominiums outpaced the gains for resale condos. According to Urbanation, the price gap between an average new-build condo launched and sold in 2018 and a resale condo less than five years old grew to a record high of $112 a square foot, up from just $46 in 2017.



Many buyers were still willing to pay a premium to get a new unit in a prime location, real estate agents say. And confident buyers believed the market price of a prebuild would continue to rise before the project is finished several years down the road.

But the growing price gap has deterred some investors, who are becoming concerned enough to lead a pullback in sales.

Mizan Rahman owns a condo unit in central Toronto that he rents out. He also bought two preconstruction units over the past few years that he expects to be completed and delivered this year. But the Toronto real estate agent says he wouldn't buy a new one now, especially downtown.

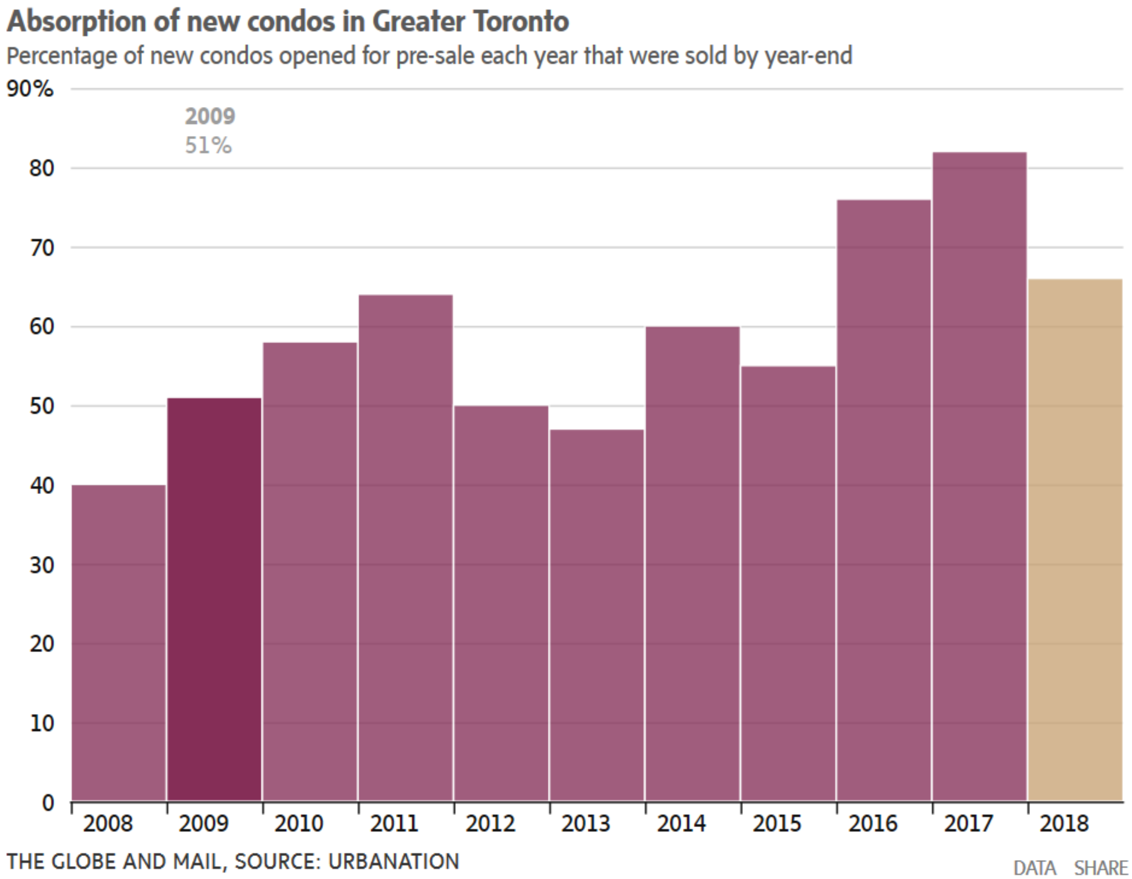
"If someone wants to invest money in a new condominium, it's not the right time to do it right now because prices are sky high," he said.

He says it makes sense to wait until more buyers return to the low-rise home market as the price gap narrows, which would take some of the pressure off condo prices.

Other investors are coming to similar conclusions, said Shaun Hildebrand, president of Urbanation. He says a slowdown in investor interest can be seen in the rate at which new projects are selling at launch. Investors typically buy as soon as projects open for sale, he says, to get the best units before they sell out.

In 2016, as the condo market began to soar, 76 per cent of new condos opened for presale sold within that year. By 2017, that rate climbed to 82 per cent. But it began to slide in 2018, dropping to 65 per cent for the year as a whole and even lower late in the year.

It is still above the 53-per-cent average over the past 10 years, but "it is starting to show that investors are starting to act with a bit more caution in the market, which they should," Mr. Hildebrand said.

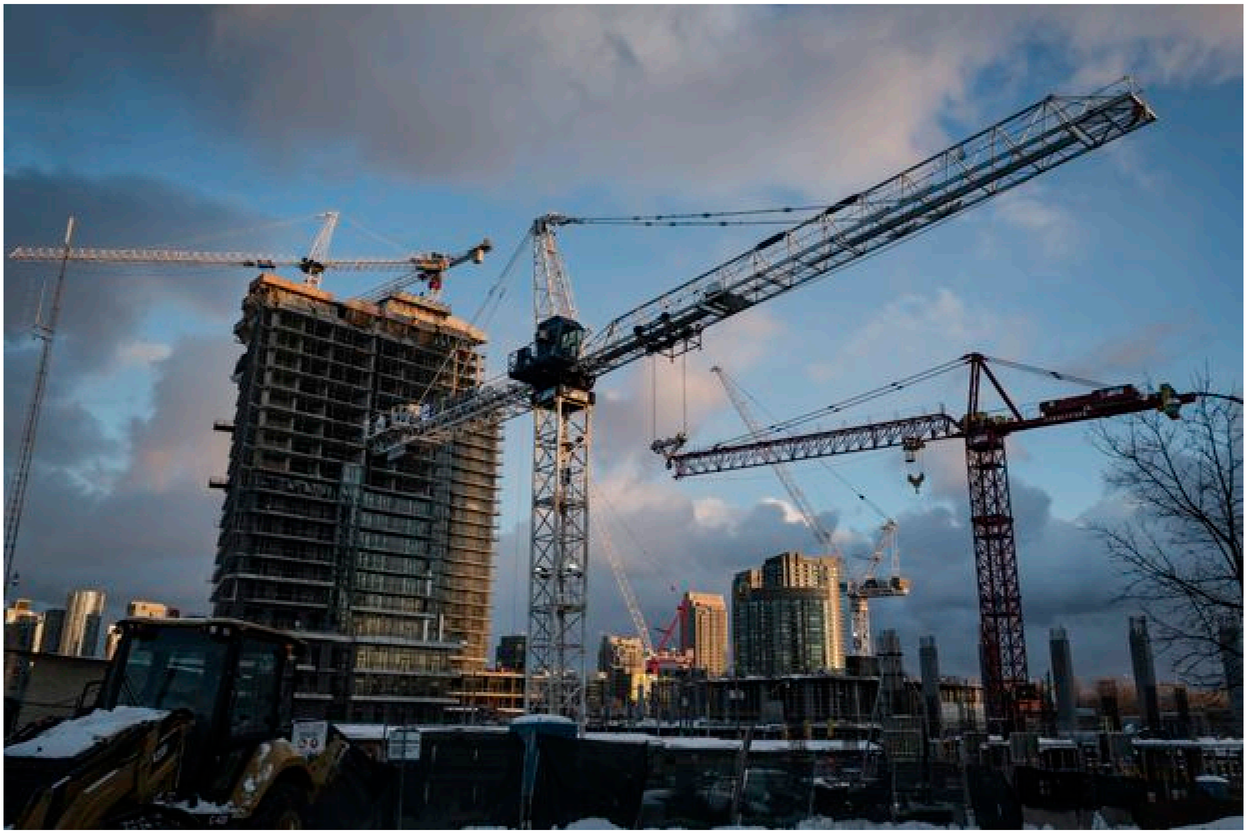


A main reason for that extra caution has been the shifting math on the region's rental market.

Investors have been willing to pay more for condos because they could rent them out for ever-higher amounts to cover their costs. But while the average rent for condominium apartments has climbed 19 per cent over the past two years, Urbanation says, prebuild sale prices are up 56 per cent over the same period.

According to a 2018 study by CIBC World Markets economist Benjamin Tal and Mr. Hildebrand, investors took possession of 48 per cent of completed condos in the GTA in 2017 – and at least 44 per cent of those investors were in a negative cash-flow position, in which the rent they charged tenants was not enough to cover their mortgage costs, maintenance fees and property taxes. More than 34 per cent of those had a shortfall of more than $1,000 a month, and a further 20 per cent were losing between $500 and $1,000 a month.

Mr. Tal said further price increases and a series of interest-rate increases announced since the completion of that report in 2018 mean investors are facing even higher mortgage costs, which will push some out of the new-build market. The cash gap was already a negative for many, he said, "but the point is, it's more negative."


For newly built condos delivered to buyers in 2018, the average rent required to cover mortgage costs, condo fees and property taxes was $2,200 a month, Urbanation calculates.

According to an IPSOS survey conducted in November, 62 per cent of people who own residential investment properties in the GTA said they were likely to list the properties for sale over the next year.

IPSOS vice-president Sean Simpson says the high level of possible sales could be a result of the declining profitability of rental units or factors such as tougher new rent-control rules introduced in 2017, which the Ontario Progressive Conservative government is lifting for newly built units that have never been rented before.

"If growth in home prices is going to slow, maybe their investment could yield a better return elsewhere," Mr. Simpson told a recent housing forecast event in Toronto. "Rent controls exacerbate that feeling, or vacancy taxes. It's not a huge chunk of people, but that may have an impact here."

For newly built condos delivered to buyers in 2018, the average rent required to cover mortgage costs, condo fees and property taxes was $2,200 a month, Urbanation calculates. (That assumes a 25-per-cent down payment, a 25-year amortization and an interest rate of 3.5 per cent.)

For many investors, the rent level puts a purchase within reach, with condo rent in the GTA averaging $2,310 in the fourth quarter of 2018.

However, someone paying the current average presale price in the GTA would need rent levels to climb almost 50 per cent, to $3,200 a month, by the time the unit is completed and delivered in four years, assuming interest rates don't change, Urbanation says.

Some investors are persisting, expecting rents to continue growing rapidly. But Mr. Hildebrand is not convinced that will happen. With more condominiums scheduled for completion in the next two years, supply is forecast to grow substantially. The record numbers of new condos sold in 2017 will also start construction soon, which means even more supply is coming in three or four years.

"In an environment where we're seeing condo completions at record highs, averaging more than 20,000 units a year, it's unlikely we're going to see rents grow at the rate they have been over the past couple of years," he said.

If investor demand for new-build condos is starting to slow, there is no evidence of falling demand from people shopping for a home – what the industry calls end-user buyers.

People buying condos for themselves are a pillar of the new-construction market – typically the most stable buyers, less constrained by a need for rapid price appreciation or worries about rental income.

Many end-user buyers are happy to pay more for a new unit because they can get exactly what they want, says Paul Johnston, a real estate agent at Right At Home Realty Inc. in central Toronto. They can pick their floor plans and customize decor details. And many new condo buildings are in desirable locations that haven't traditionally been available to such buyers.

"If you're shopping for a condo on Bay Street, that [price] gap between resale and new construction might be hard to understand, but if you're looking in more niche, walkable, mid-rise neighbourhoods, there is less choice," Mr. Johnston said.

That doesn't mean such buyers will buy everything that comes to market, however.

From a distance, Toronto's preconstruction condominium market has looked like the last remaining bubble in the city's overheated real estate market, with prices hitting a record high in 2018 and the average unit selling for more than $1,000 a square foot in central Toronto, according to Urbanation.

CHRISTOPHER KATSAROV/THE GLOBE AND MAIL

The "intensity of demand" is not as strong as it was in 2017, says Jim Ritchie, executive vice-president of sales at condo developer Tridel Group, and the bestsellers are units in what he calls triple-A locations – such as the city's core and close to major transit lines. But units outside the downtown will sell well if they are aimed at the right buyers.

"People tend to look at it as one big market, but it's not. It's many sub-markets. You have to look at who it's being sold to, where it is, whether it is a big building in the core with small suites versus something designed for end-users, with bigger suites and bigger wallets."

Jared Menkes, executive vice-president of high-rise residential condo builder Menkes Developments Ltd., says buyers are increasingly favouring established developers after almost 6,000 planned condo units were cancelled in the GTA in 2017 and 2018, most of them sold several years earlier at prices far below current market levels.

That's making buyers look more carefully at who is behind a project, he says. While some competitors lowered their required deposits last year to 15 per cent of the total purchase price, Mr. Menkes said his firm raised its required deposit on its new Sugar Wharf waterfront project to 25 per cent.

The development, launched last summer, is already 80-per-cent sold out, while a neighbouring project is struggling, Mr. Menkes said. Buyers were willing to pay tougher financing terms because "they knew their money was safe with us," he said.

Some of the slowest sellers in 2018 were buildings with units priced at more than $1,000 a square foot, real estate agents say.

Al Daimee, a realtor based in downtown Toronto at Royal LePage Signature Realty, says some developers have gotten ahead of the market. Projects launching last year for as much as $1,600 a square foot are pushing into a new price echelon, but it isn't sustainable in many cases.

"The better-quality buildings will be snapped up, and the ones with lesser-known developers, or not ideal locations, or that price themselves up too high for what they have to offer, are not going to see a lot of activity," he said.

Zev Mandelbaum, a long-time Toronto developer who recently launched a new firm called Altree Developments, says Toronto's condo sector is coming up on an affordability maximum.

The future direction of construction costs is a key factor to watch, he says, because if those expenses continue to soar, builders aren't going to be able to sell units at prices needed to cover buyers' costs.

"We've reached a ceiling on most of the pricing in the downtown core," he said. "There may be a few more dollars we can go up, and good projects will continue to grow at a steady pace, but not at the breakneck pace we've seen."

Paul and Kelly Bannister are photographed at the Art Thompson Iceplex in Pickering, Ont. The couple bought a unit at a condominium that will be built on the lot where the arena and parking lot are located.

FRED LUM/THE GLOBE AND MAIL

One clear sign the market is tightening is that some developers are offering more incentives to woo buyers, especially investors.

Some are stretching the time buyers have to pay deposits or are lowering the required deposit percentage. Others are guaranteeing investors that they will find tenants for them for up to two years after closing, while some are offering discounts on maintenance fees – even up to a year with no maintenance fee payments at all, real estate agents say.

Paul and Kelly Bannister bought an investment condo unit in 2018 in the University City project planned for a site next to the Pickering GO Transit station, and were attracted by the financing terms, which gave them plenty of time to pay the required 20-per-cent deposit.

They were allowed to pay 5 per cent within 30 days, with the remainder due in five increments of 3 per cent each, stretching over two years, including a final 3 per cent at closing, he said.

Mr. Bannister said he is in no rush to take delivery, and any premium on the $425,000 purchase price compared with a resale condo will likely be erased by the planned completion date in 2021.

“[The price] is probably a little bit more than what it would cost to go out and just buy immediately now, but with the structured payment plan where you’re putting 3 per cent down every 90 or 180 days, by the time they break ground you’ll have your deposit down,” Mr. Bannister says.

In the end, investors aren’t wooed by incentives but by the potential for long-term price increases

Many market participants are confident that the core end-user demand for condos will remain strong in Toronto because of the region’s growing population and strong employment rate, providing a strong base for the industry. But the wild card is investor sentiment, which can make the new-build sector soar or stagnate given the large proportion of investor buyers.

What investors want most is the lure of large profits from soaring market prices, says ***Anthony Scilipoti***, CEO of Toronto-based ***Veritas Investment Research Corp.***, who monitors the GTA's new-build condo sector and "mystery shops" for a new condo every year to monitor firms' sales practices.

If prices don't rise in the new-build market – even if they simply plateau for a while – he says some investors will be deterred by the slow rate of appreciation. That sentiment could be a worst-case scenario for the industry, he says.

If new investors don't see a potential for ample value growth – enough to justify carrying a rental property at a monthly cash loss – they could withdraw in larger numbers, pulling the biggest source of heat out of the Toronto market. And if investors who purchased condos start to list them for sale after taking delivery because the carrying costs are too onerous, the pain could also spill into the resale market as inventories climb.

"A bubble is sustained by the next guy coming in and being willing to pay more," Mr. Scilipoti said. "If the price doesn't go up, the new guy says, 'I'll just watch and see.' And the longer it doesn't go up, the longer he just watches."