VERITAS INVESTMENT RESEARCH

December 13, 2019

CANADIAN HOUSING MARKET PERSPECTIVES

Communications & Strategy

Scott Adams
sadams@veritascorp.com

Canadian Housing Market Perspectives

A few years ago, Canadian prices for detached houses were spiralling upwards, with no apparent link to affordability. To slow the climb and likely to appease voters, governments of all stripes stepped in with regulations. The interventions took the wind out of detached prices but had the unintended consequence of lighting a fire under prices for more "affordable" properties, condos in particular, with the knock-on effect of driving up rental rates.

In short, Canada's major markets are now no longer affordable for rental or ownership, even as Canadians' debt service ratios cross through all-time highs, and insolvencies begin to rise. Investors also remain a key piece of the puzzle.

At Veritas, we spend a lot of time following the housing sector. It is often an early indicator of the health of the Canadian economy and the direction of Canadian equities, especially bank stocks.

Debates over Canadian real estate have become a national pastime. In this report, we summarize the views and debates raised at our 8th Annual Great Canadian Housing & Real Estate Conference held on October 2.

We hope it provides you with additional perspectives on Canada's real estate market and the associated risks.

This year our experts covered:

- The impact of the B20 mortgage stress test;
- The economics of condo rentals in the GTA;
- The constraints within the new construction market, including red tape;
- Why there is a rush to apartment development;
- The danger that real estate investors exacerbate a house price correction;
- The expectation for increased volatility in the Vancouver condo and housing market;
- The truth behind the rapidly growing shadow mortgage market;
- How foreign investors are laundering through our Canadian banking system;
- A bubble of stretched consumers;
- Sidewalk Labs and potential innovations in urban planning and construction.

Here are excerpts from the presentations (our clients received full summaries, in addition to full videos and slide decks of the presentations as permitted). Don't miss next year's 9th annual Housing Conference in October.

Gregory Klump, Chief Economist - Canadian Real Estate Association

When it comes to credit quality, we wanted to look at the creditworthiness of mortgage borrowers before and after the mortgage stress tests were introduced. To do this, we commissioned some credit quality data from Equifax for successful mortgage applicants of the big five banks. We found that credit scores associated with mortgage originations were running high even before the stress tests were introduced, whether you're looking at Toronto, Vancouver, all of Canada, or younger home buyers.

"Canadians are really responsible when it comes to paying their mortgage debt obligations, which invites the question, could maybe the mortgage stress test be better constructed so that it better targets reducing mortgage credit growth to the highly indebted borrowers?"

Video

Shaun Hildebrand, President - Urbanation

Rental rates have inflated quickly, and that has added fuel to pre-construction condo prices. We are at a point now where there are a record high 70,000 condo units under construction in the GTA, he told the conference.

"This is a quantity of supply pre-sold to investors that the market has never seen," Hildebrand said. We don't usually hear much about closing risk. Investors usually put 15% to 20% down, and no one is willing to walk away from that kind of money. But we're hearing more about closing risk now because we don't know what the economy will look like when the units are completed a few years down the road.

Rents per square foot are growing at about 5% year over year, down from 10.7% at the peak in Q2-2017. In 2017, we found that about half of condo investors were cash-flow negative and half positive. That has been changing with rental growth in the last few years, as more investors now can make a couple of hundred bucks per month on their condo rentals. However, based on the prices we're seeing people pay for condos now, even with low-interest rates, we're going to need to see rents rise 40% by 2022 or 62% by 2023 for them to be cash flow breakeven. Or people are going to have to put more money down to de-lever their investments.

Video

Richard Lyall, President – Residential Construction Council of Ontario

Ontario's development and building approval process is much slower and less innovation-friendly than many advanced jurisdictions. Approvals that should take about a month can now take more than two years. The World Bank currently ranks Toronto 63rd among 190 countries for development approval efficiency.

A University of Toronto study found rezoning took less than a year in 2006 and took more than three years in 2016. Inconsistent evaluations, prescriptive regulations at the provincial and municipal levels, and inefficient processes create the bottlenecks. Other countries like Germany and Japan are moving ahead of us, continued attention is required.

Video

Anna-Maria Kaneff, Executive Vice President - Kaneff Properties

Historically, a developer would choose condos nine times out of 10 over purpose-built because of the holding period. But the landscape has changed. From a developer's perspective, there are three key reasons why apartment building, or purpose-built housing, is more attractive now than in the past few decades:

- Demand has outstripped supply significantly for the last ten years. Vacancies are below 1% in Toronto — 3% is considered a healthy balance.
- Rents are increasing at a faster pace than the supply coming on stream.
- Access to capital is better. With investment-grade bond yields so low, institutional investors are looking for long-term stable cash-flow investments. CMHC also provides fixed-rate financing for purpose-built through the development process.

Nigel D'Souza, Financial Services Analyst - Veritas Investment Research

Housing stock levels usually rise during a recession like in 2008 and 1990 when people are forced to sell their homes — this is the kind of supply shock that results in an extreme buyers' market and house price crashes.
"Real estate investors and speculators are the ones that are most likely to flood the market with supply if conditions change. If economic conditions change, if unemployment goes up, if there's a recession, if interest rates move higher, if sentiment changes, they're the ones that are going to list."

We surveyed real-estate investment property owners and found that although 84% said they don't plan to sell in the next 12 months, 64% said they do not plan to buy another property. Perhaps that is because half of the people in the survey admitted being either breakeven or losing money on their properties. "If we have a recession, these are investors who will be hard-pressed to financially support negative cash flows through a recessionary environment."

Video

Christine Duhaime, Lawyer - Duhaime Law

There are over 200 different laws and regulations and policies related to foreign currency conversion and moving money out of China. The Chinese government has cracked down on foreign currency conversion and money leaving China where it involves fraudulently activity in recent years.

What's happening in China is fraud — bank fraud, ID fraud, and often trade based money laundering with doctored and fabricated invoices and sales contracts — to exit money so someone can buy a mansion in Vancouver.

Those are the offences in China under Chinese criminal law and those offences are also indictable offences in Canada, so banks need to be careful about the proceeds of corruption from China, and to have greater knowledge about the laws of China because that's what is relevant. The movement of money by fraud is a criminal offence in both countries and that means banks need to be cautious about dealing in such funds and importing such funds.

Steve Saretsky, Real Estate Agent - Saretsky Group in Vancouver

Foreign house buying in the Vancouver market has slowed. To support sales, the developers are getting creative by offering incentives like free avocado toast, free Teslas and $100,000 in realtor bonuses. But the risk remains. If you get a 20% pre-construction deposit on a pre-sale from a foreign buyer and they don't close, how will that $3,000 per-square-foot condo get absorbed by the local market? "I don't know what the local demand is for these high-rise condos at $3,000 per square foot."

There is also a growing glut of units for sale in the market. "There are a lot of people that are looking to flip these condos, and unfortunately, that market has become extremely illiquid. Buyers have a lot of options right now. The condo market is relatively soft. People aren't interested in unfinished condos."
This is worrisome because you have a record high of 45,000 condo units under construction now. "Given that a lot of the pre-sale condos are geared towards investors, how many of them are looking to flip, and are they going to be able to get out, and then vice versa, are they going to be able to close?"

Video

Albert Collu, President - M3 Mortgage Group Inc.

People are still finding ways to get into homes despite stress tests and onerous government policies. So, how is that happening?

"What you're seeing is the displacement of what we used to call the securitized model. We're seeing it go to privates, mortgage investment corporations, and for lack of a better phrase boutiquey money."
A few years ago, the alternative or subprime market represented about 3% to 5% of new originations. "Today, what we can measure is probably closer to 30%. That's crazy, right?"

If you were to walk into a bank pre-stress test in 2016, one in five Canadians would be rejected for a mortgage for whatever reason. That is now close to two in five. That is pushing those consumers into "shadow" or "gray" markets. Everyone has a different definition of shadow markets. It doesn't mean everyone who doesn't go to banks. There are non-bank institutions that are sophisticated and regulated. The shadow market is private, unregulated, untracked lending, and that is probably 9% to 11% of the mortgage origination market now.

Video

Scott Terrio, Consumer Insolvency Manager - Hoyes, Michalos & Associates

Insolvencies are cyclical. They lag recessions by a couple of years, and typically peak about every six years. The last peak was after the 2008 recession in 2009, with 148,000 insolvencies. “We missed a cycle in 2014-15, and now you have this consumer debt bubble, which is massive because of housing, low-interest rates and a great stock market for a long time.”

Insolvencies are event-driven, happening when people get sick or divorced, but we’re seeing increasing numbers of insolvencies for “renovictions,” where a landlord finds a way to evict a tenant paying below-market rent for one reason or another, and the renter gets into financial difficulties once they have to pay market rents. “It is nothing for me to see people spending 50%, 60% of their net after-tax income on their shelter. It's a big problem.”

Video

Marc Ricks, Head of Corporate Development - Sidewalk Labs

Sidewalk's mission is to combine urban design with cutting-end technology to improve cities. Waterfront Toronto selected Sidewalk Labs for the eastern waterfront project. We talked to 20,000 people over 18 months about the project and released a 1,500 page-document called Toronto Tomorrow. Some proposals are technology-based, while others argue for construction innovation.

"To change the city for the better, we think real cities need an integrated approach where you try to bring together all of the different, not merely technological solutions, but let's call them old-world solutions into one package to try to change urban life for the better."

Head of Research	
Sam La Bell, MA, MBA, CFA slabell@veritascorp.com	

Vice President of Communications & Strategy	
Scott Adams sadams@veritascorp.com	

Accounting & Special Situations Group	
Dimitry Khmelnitsky, CPA, CA dkhmelnitsky@veritascorp.com	**Brent Levenstadt**, BA (Hons), CPA blevenstadt@veritascorp.com
Chris Silvestre, CPA (Delaware) csilvestre@veritascorp.com	**Henry Yu**, CPA, CA hyu@veritascorp.com

Consumer Staples & Discretionary	Industrials
Kathleen Wong, CPA, CA, CFA kwong@veritascorp.com	**Dan Fong**, BA, HBA, CFA dfong@veritascorp.com
Lucas Shwed lshwed@veritascorp.com	

Energy	Communication Services, Information Technology & REITs
Jeffrey Craig, CPA, CA jcraig@veritascorp.com	**Desmond Lau**, CPA, CA, CFA dlau@veritascorp.com
	Howard Leung, CPA, CA, CFA hleung@veritascorp.com

Financial Services	Utilities & Infrastructure
Nigel D'Souza, B.Sc., CFA ndsouza@veritascorp.com	**Darryl McCoubrey**, CPA, CA dmccoubrey@veritascorp.com
Shalabh Garg, MBA, B.Eng. sgarg@veritascorp.com	

Client Support & Business Development	
Mickey MacDonald, CPA, CA mmacdonald@veritascorp.com	**Tom Jarmai**, B.Sc., BA, FCSI tjarmai@veritascorp.com

Our Vision

To seek the truth from the facts.

Our Mission

To be our clients' trusted source of independent knowledge and advice.

Veritas Investment Research Corporation
TD West Tower
100 Wellington Street West Suite 3110, PO Box 80
Toronto, Ontario, Canada M5K 1E7

416.866.8783
www.veritascorp.com