Disruption In Residential Real Estate and Construction

Industry Leaders Discuss Today's Challenges and What's Next

Canada's real estate and construction sectors face an increasingly complex and unpredictable marketplace across North America. To get an insider's view of the industry, in the Fall of 2018, MNP hosted a roundtable discussion with Canada's leading residential real estate and construction companies, as well as key asset management corporations.

The event resulted in a candid discussion of the challenges, emerging opportunities and disruptions that lie ahead and how executives are shaping their strategies and companies accordingly. This whitepaper summarizes the top-of-mind concerns addressed during the roundtable.

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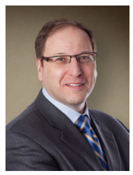

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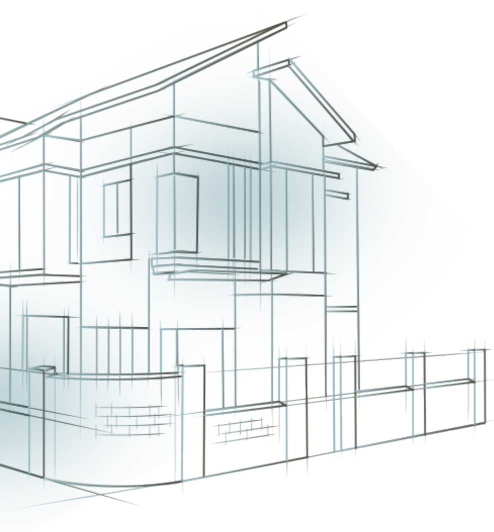


PRESENTER

David Onyett-Jeffries
Vice President, Multi Asset Class Solutions, Guardian Capital LP
Guardian Capital LP manages institutional assets for pension plans, insurers, foundations, endowments, third-party mutual funds and exchange traded funds.

ROUNDTABLE PARTICIPANTS

Frank Bartello – Senior Vice President, Acquisitions and Asset Management
Guardian Capital Real Estate GP Inc.
GCRE, which is part of the Guardian Capital Group, has a diversified portfolio of direct Canadian real estate investments comprising small and mid-sized commercial (industrial, retail, office) and multi-residential properties in primary Canadian markets.

Karl Brady – Chief Financial Officer, Greybrook Realty Partners Inc.
The real estate investment and asset management division of Greybrook Capital, Greybrook Realty Partners has invested in more than 50 North American real estate developments with an estimated completion value of $14 billion. The firm's portfolio includes a diversified mix of low-rise and high-rise residential, purpose-built rental, as well as commercial development.

Carmelo Caruso – Chief Financial Officer, Easton's Group of Hotels and The Gupta Group
Gupta Group is a multi-faceted Toronto development company with a real estate portfolio of residential condos, office towers and hotels, including industry-renowned brands such as Marriott, Hilton, IHG, Starwood and Choice Hotels.

ROUNDTABLE PARTICIPANTS cont'd

Jonathan Levinoff – Vice President, Finance, CentreCourt Developments
CentreCourt focuses on the development of high-rise residential communities across the Greater Toronto Area. The company currently has 10 projects in various stages of development, collectively representing more than 5,000 homes and over $2 billion of development value.

Bryan Levy – CFO, Preston Group
Preston Group has a rental portfolio of more than 1,200 apartment residences in buildings across the Greater Toronto Area.

Paul Paletta – Vice President, Penta Properties Inc
Penta Properties is a building owner and property developer with numerous residential, retail, industrial and office properties throughout the Greater Toronto Area and the Hamilton-Niagara regions.

Ari Silverberg – President, Harbour Equity Capital Corp
Harbour Equity is a leading capital provider for developers in urban markets throughout Canada. The company has invested in 38 developments, which on completion will comprise over $1.5 billion in real estate value, in asset classes including for-sale and purpose-built rental residential, retail, office and industrial developments.

Phil Soper – President, Royal LePage
Royal LePage is the country's leading provider of services to real estate brokerages, with a network of close to 18,000 real estate professionals in more than 600 locations nationwide.

TOP CONCERNS

"We're going into the 10th year of economic expansion. This is the second longest expansion since the turn of the 1900s. The concern is: when will this end?"

- Economist David Onyett-Jeffries of Guardian Capital

David Onyett-Jeffries provided an overview of Canada's economy, offering cautions as well as reassurances on multiple fronts.

Continuing economic expansion, but more moderate

Canada is starting to see some moderation in growth, David said. "Ultimately, we're going to be constrained by population growth. But there is some growth and that is positive."

U.S. influence: New trade agreement between U.S., Mexico and Canada (USMCA) alleviates uncertainty; investment inflows rising

He commented that uncertainty around trade policy with the U.S. has been restraining growth.

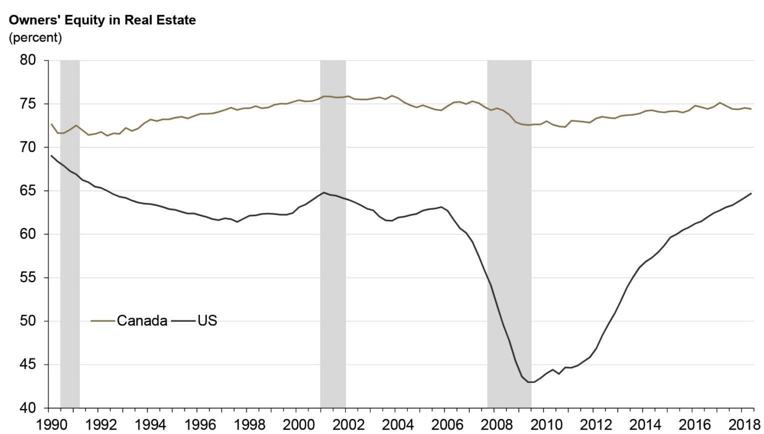
Now that the USMCA agreement is in place, he sees investment inflows beginning to increase. Moreover, since Canada wants to attract investment, David suggested the Bank of Canada will raise interest rates only very gradually through 2019. "It took so long for the global economy to get back on its feet, policy makers will exercise a high degree of caution," he said.

Household balance sheets still okay; mortgage defaults not rising

On the issue of potential mortgage defaults as a result of rising interest rates, David pointed out the rate of mortgages that are 90 days in arrears is currently only 0.4 percent of mortgages outstanding – an extremely low number. By comparison, in the lead up to the financial crisis, in the U.S. the rate was close to 1.5 percent, ultimately spiking to about 25 percent.

Homeowners' Equity as a Percent of Real Estate Assets

David noted the media focus on households in Canada having extreme amounts of leverage, with comparisons to the 2006 / 2007 U.S. housing market crash. Looking at the debt-to-income ratio, David pointed out Canada was still about 20 percentage points away from where the U.S. was at its peak.

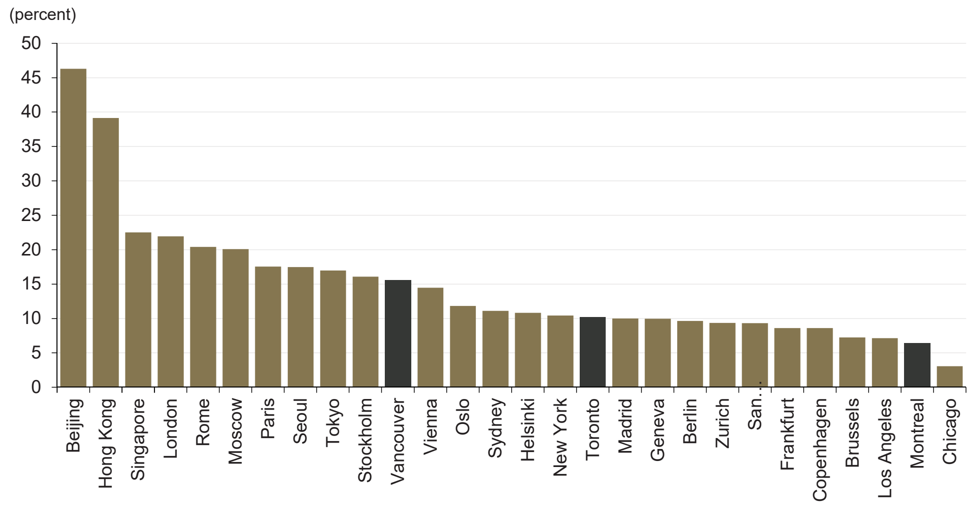


It's important to consider not just the liability side of household balance sheets, but also the asset side, he said. "On average, Canadian households have 75 percent equity in their homes – a lot of skin in the game." This ratio has been almost constant since the 1990s and higher than the U.S. has had over past 30 years. David also reminded the group Canadian financial institutions in general continue to be significantly more conservative than U.S. lenders.

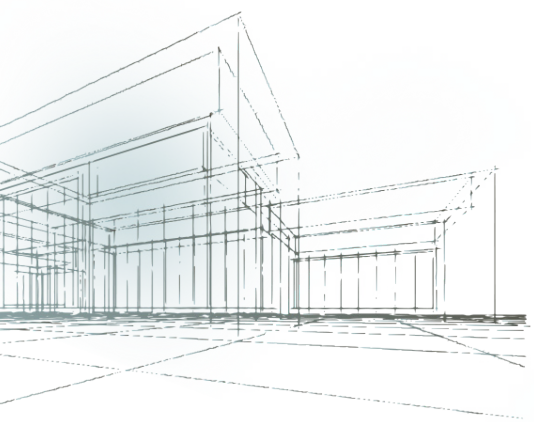
Across Canada, housing prices keeping pace with incomes and inflation; Vancouver and Toronto markets similar to global peers

Over the last five years, annualized increases in home prices have been about seven percent, "which is robust," David pointed out.

House Price-to-Income Ratio



Source: Numbeo, Guardian Capital



Canada's housing market is being driven by Toronto and Vancouver and their surrounding areas. "These cities have among the highest influx of immigration in the world, especially skilled immigration," David said. "You have population growth and strong industries in these cities in particular, but not a lot of land to build subdivisions. When you have strong demand and limited supply, the balancing mechanism is price. Prices rise."

While home prices in these cities are becoming more expensive relative to income earned, David said Toronto and Vancouver still do not stand out among their global peers when comparing home price valuations worldwide. He added that outside of Vancouver and Toronto, generally housing prices in the rest of the country have been keeping pace with either inflation or incomes.

Regulations targeted to removing froth from housing market; prices stabilizing

While news stories often raise concerns about escalating leverage among home owners and buyers, there are fundamental reasons for what we're seeing in the housing market.

Rather than dampening the economy by raising interest rates, policy makers are targeting regulations to "take the marginal froth out of the housing market," David said. In B.C. and Ontario, foreign home buyer tax credits were introduced to reduce speculative investing. In January, Guideline B-20 of the Office of the Superintendent of Financial Institutions took effect. These regulations require lenders to test borrowers' ability to pay higher interest rates. The result, he suggested, is that home prices are starting to stabilize.

The challenges of driving revenue growth

Following the presentation, roundtable participants spoke frankly about the challenges of growing their businesses in an environment of economic, political, demographic and market disruption.

Concerns about interest rates moving higher and their impact on cost of capital

One of the first questions raised by the table was about possible mortgage default increases amid rising interest rates. David said rates won't be increasing enough to reach the point where cost of capital "is prohibitive to any type of expansion, especially over the next 18 months. It's very unlikely we'll get to 10 percent or even six percent market interest rates again."

Lenders remain bullish on residential construction projects

MNP asked participants whether financial institutions continue to be supportive of their growth objectives, given rising land and construction costs, increasing government fees and often lengthy approval processes.

Jonathan Levinoff of CentreCourt Developments said he hadn't noted any recent tightening in construction financing requirements. "When you have a relationship with a lender and present a good project, that's substantially sold, you're getting deposits in a timely manner, your budget's in line and your margins are there – they're pretty bullish in underwriting the deal."

He confirmed this was similar for land deals. His company recently closed on a deal on an unzoned site downtown with a Schedule 1 bank. "It was on very aggressive terms so we're pretty happy about that."

Carm Caruso of Easton's Group of Hotels and The Gupta Group suggested "this speaks to the future of the greater GTA; I think we're all believers in the strength of the area."

Rising cost of inputs is a serious and escalating issue

Costs were another concern for roundtable participants, especially in light of the tariffs imposed by the U.S. and the countermeasures they triggered.

Prices for steel, aluminium and softwood lumber have all increased this year. According to the Residential Construction Council of Ontario, the increased cost of steel in the province could add between $10,000 and $12,000 to the cost of an average condominium unit.

Labour shortages are another contributor to higher costs. In a recent survey, the Business Development Bank of Canada found the construction industry was among the hardest hit by shortages, often having to pay more to attract workers.

Guardian Capital's David Onyett-Jeffries mentioned overall unemployment rates in Canada are currently extremely low. "Not just cyclical lows but generational lows," he said "This means opportunities to expand a business are limited by the availability of workers." He cautioned prices start to rise when there is demand but limited inputs into production.

Jonathan Levinoff of CentreCourt agreed, adding "Construction cost increases on virtually all supply inputs from rebar to concrete have been significant, probably escalating 15-20 percent on our projects over the last two years." These challenges, he says are making a lot of developers pause and weigh the question "where are we going to get the best risk-adjusted returns going forward?"

Project approval processes have become slow and costly

The prolonged project approval process, especially in Toronto, was a particularly frustrating issue for this group.

The time to complete the approvals process for **174** Toronto condo projects between 2006 and 2016 **more than doubled** over this decade.

-Evaluation of Tall Building Construction Permitting Process in Toronto

Growing policy and regulatory controls and insufficient staff members to facilitate the approval process are increasing uncertainty and risk for developers. In turn, they believe this is restricting supply and escalating prices for home buyers.

Carm Caruso of Easton's Group of Hotels and The Gupta Group noted what used to take six to eight months now takes three to four years. "When you limit supply, prices go up," he said. "If they would hire more people at City Hall to help push projects through, we'd have stabilization in pricing."

Government charges are another impediment to launching new projects, the roundtable said. "City Hall expects so much money from developers that it pushes numbers beyond what is attainable for local people to afford to buy," Carm said.

PERMIT TIMELINES ACROSS CANADA

Across GTA municipalities, it takes **18.2 months** (on average) to obtain permits, costing almost **$50,000 per unit** (on average) in fees.

Across Alberta's Calgary-Edmonton Corridor, and Vancouver and its surroundings areas, it takes almost a **full year** to obtain permits, triggering around **$30,000** in per-unit fees.

In Vancouver, approval timelines are almost **two years**, and fees climb to just under **$80,000**.

Clearly, local land-use regulations can significantly reduce the number of much-needed new homes (for renters and buyers alike).

Source: Fraser Institute

In Ontario, appeals body change from OMB to LPAT escalates risk: For these executives, another recent policy change in Ontario has contributed a new layer of uncertainty to the development approval process.

In April, with the intent of making the development proposal appeals process faster, fairer and more affordable, the Ontario government replaced the Ontario Municipal Board (OMB) with the Local Planning Appeal Tribunal (LPAT). Unlike the OMB, the LPAT cannot overturn municipal decisions that follow municipal official plans and provincial plans. Moreover, there is a strict appeal test the LPAT will follow and there will be no de novo hearings for the majority of land use planning appeals. This suggests fewer decisions can likely be appealed.

For developers, there are many unknowns about the new process. For example, while there are established timelines of about 12 months for the LPAT to make a decision following the Notice of Commencement, it's not yet clear if or how these timelines will be enforced. As well, the LPAT has the option of deciding whether more time is needed.

There are also detailed requirements for written submissions, which could necessitate substantial investments of time and resources for developers. As well, the LPAT provides local communities with more resources, which could generate greater opposition to developments.

Karl Brady of Greybrook Realty noted industry assumes LPAT will give developers no protection. “For this reason I think we’re seeing a slowdown in land that isn’t fully approved,” Karl said. “Some developers aren’t as willing to take that risk.”

“It’s not easy for developers to get zoning at the best of times,” added Jonathan Levinoff of CentreCourt. “Now, with the transformation of the OMB to the LPAT, we’re being really diligent about where we make our next move. Our outlook is that when we buy a property, we’re going to structure a deferred closing and mitigate the zoning risk to the extent possible.”

Government policies deter development of purpose-built rentals

MNP asked roundtable participants whether they were considering purpose-built rentals for their portfolios, in the context of the Canada Housing and Mortgage Corporation (CMHC) program that provides insurance to builders of rental housing for lower interest rates.

Historically low vacancy rates in many cities across the country spurred the federal government to include this program in its 2018 budget. In Toronto the vacancy rate is 1.1 percent and Vancouver is at 0.9 percent, indicating a significant imbalance of demand and supply of rental units.

Ari Silverberg of Harbour Equity pointed out “in Toronto it’s tough to make a purpose-built rental work considering how they compare with the yields on a condo project.” He added that for institutional investors with a long-term outlook, “it might make sense in certain situations.”

The Fraser Institute recently cautioned that red tape and costs imposed by municipal and provincial governments could undermine the intent of legislation like this. One 2017 estimate suggested that in less than a year, 1,000 units across the Greater Toronto Area, which were intended to be purpose-built rental, were converted to condos when developers determined the investment returns to build rental units were not viable.

Bryan Levy of Preston Group suggested that purpose-built rental buildings would have greater appeal for developers if rent controls were eased. “Allowing annual rent increases of 2 percent plus inflation would make more sense for developers who are underwriting at 3.5 percent growth rates for purpose-built models, while also protecting home buyers. Hopefully the new provincial government in Ontario will explore that.” Subsequent to the roundtable, the Ontario government has announced that rent control will not apply for all newly constructed rental properties.

RENT CONTROLS DISCOURAGING DEVELOPMENT IN ONTARIO AND B.C.

Last year the Ontario government expanded rent control to all private market rental housing units across the province, with 2018 rent capped at the annual rent increase guideline of **1.8 percent**.

In B.C., a provincial task force recently recommended reducing annual allowable rent increases from **2 percent** plus inflation, to inflation only.

The search for yield: where do we go, what do we build?

Amid an environment of sales and price uncertainty, finding the right balance of risk and returns was a key part of the discussion among roundtable participants.

Phil Soper of Royal LePage commented on trends his company has been seeing lately: “Volumes are down in the overpriced Vancouver and Toronto metropolitan areas and also in Calgary. The same is true even in Montreal, which has been the strongest market in recent years. Our outlook for Quebec is quite a bit more modest than it has been.”

“We had overshooting on prices not just in Toronto and Vancouver but also in secondary cities like Windsor, Hamilton, Kelowna.” He added. “Now it seems to have slowed right down. Volumes are off, but pricing is holding – and that’s what you want after a correction.”

NEW HOUSING PRICE INDEX: 12-MONTH CHANGE TO AUGUST 2018

New house prices rose **0.4%** year-over-year in August, with annual price advances gradually slowing since October 2017.

The largest 12-month gains in August were in Ottawa **(4.9%)** and London **(3.6%)**.

Source: Statistics Canada

Diversifying portfolios and markets

Several of the executives at the table said they were broadening their projects and markets in response to the need for higher yields as well as their investors wanting to expand real estate portfolios.

“We’ve diversified our portfolio by starting to acquire existing multi-family buildings for value add as we see an opportunity in this space, development projects with pricing that makes sense are harder to come across in Toronto,” Karl Brady of Greybrook said.

Projects include purpose-built rentals in Canada’s secondary cities and in U.S.

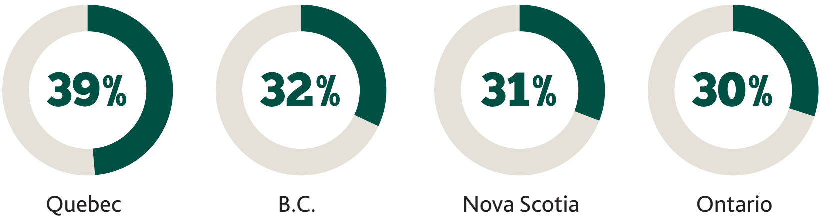
Some of the roundtable executives have been looking for opportunities to build purpose-built rentals in markets beyond Vancouver and Toronto where provincial and municipal policies hamper returns.

Several people mentioned that rentals in Montreal, Quebec City and Halifax tended to do well. Traditionally, Quebecers consider rentals favourably and in Halifax renting delivers cost advantages over condo ownership. “Halifax has a renting culture,” Carm Caruso of Easton’s Group of Hotels and The Gupta Group said, adding the market there was more receptive to rental developments.

WHERE RENTAL HOUSING IS HIGHEST

Approximately **4.4 million** adults and families in Canada live in rental housing, representing slightly under one-third of total households.

The highest share of households that rent:



Greybrook has focused on the U.S. for purpose-built rental developments. With a portfolio that includes low-rise and high-rise residential as well as purpose-built rental properties and an aim to mitigate development risk through choice of structure and locations, Karl Brady said the company has developed a few buildings in the U.S. and is also acquiring existing purpose-built rental stock there.

Karl said until recently the fundamentals for purpose-built rentals haven't been there. "But now it's starting to make more sense," he noted. Greybrook has a couple of new luxury rental projects in Miami and Ft. Lauderdale. "We think Florida is a good market for purpose-built rental. Financing is easier and the planning process is a lot simpler."

Targeting millennial preferences

Millennials are now driving Canada's real estate market, the executives point out. This cohort, which likes home ownership in established neighborhoods with amenities and schools, influences how the developers approach new projects.

THROUGH 2026, MILLENNIALS WILL BE THE LARGEST SOURCE OF HOUSEHOLD FORMATION

Across Canada, the millennial generation (those born between 1981 and 2001) is expected to more than triple the number of households – in the range of 5.5 million to 7 million, according to Professor James McKellar of the Schulich School of Business.

About 72 percent of millennial households are projected to own their own home by 2036 and the share of couples with children is projected to be about 29 percent by 2036.

A recent report by Ryerson University's Centre for Urban Research and Land Development indicates most will prefer ground-related homes (singles, semis and townhouses) when it comes time to purchase. To satisfy their household and locational preferences they will look to existing neighbourhoods, with high-rise condo as the default or short-term option.

Karl Brady of Greybrook mentioned seeing "more end users buying in units than we've seen before." These are people who live in the homes they buy, rather than investors who rent or resell.

Downtown is in – for now

For now, many of these millennials want to be downtown.

"The clustering of people and jobs in downtowns is driving vertical growth. A significant feature…of cities that are expanding vertically, like the GTA… is the increasing concentration of desirable higher-wage jobs, choice retail outlets and other amenities catering to well-paid workers and residents. But… in vertically expanding cities, zoning and land use regulations compounded by the effects of NIMBY sentiment are increasingly restricting new housing supply."

- Professor James McKellar, Schulich School of Business

Jonathan Levinoff of CentreCourt agrees people want to be in the core where they can work and play "and they're willing to sacrifice for it. They are willing to live in a 500 sq. ft. one-bedroom unit."

Bryan Levy of Preston Group added people are also willing to rent and this is driving demand for rentals.

White picket fence still a dream for millennials with children

Rental? Condo? High rise? Mid-rise? Townhouse? Single family home? The group debated millennial home preferences.

Phil Soper of Royal LePage referred to recent research by his company, which found that young people who grow up in city cores, tend to stay downtown when they become couples and move in together. He said that "it's usually after couples have a second child that they move to the suburbs, just like their parents. Partly, this is because we don't provide enough multiple bedroom units in projects because the return is not great. But I feel the white picket fence is still a dream for people with multiple children."

Anticipating the baby boomer to millennial home switch

Many baby boomers are still living behind those white picket fences. Phil Soper pointed out that baby boomers have been quiet on the real estate trading side for about 15 years because their kids – the millennials – have hung around much longer than expected.

More than a third of millennials in Canada live at home with at least one of their parents. In Vancouver that number is 39 percent and in Toronto it's 47 percent. Still, he said "over the next five years, we think there'll be 1.4 million baby boomers selling." And, given the 2018 Royal LePage Boomer Trends Survey indicates 56 percent of boomers consider their local housing market unaffordable for retirement, it's likely they will head for smaller cities and recreational areas." They're not necessarily going to buy a 750 sq. ft. condo in the city, but rather a 2,000 sq. ft. townhouse in Burlington or Collingwood or Saskatoon," Phil said.

He believes that as baby boomers sell their homes and millennials consider alternatives to the major cities, this shifting could alleviate some of the housing supply pressures in the major cities.

ROYAL LEPAGE PEAK MILLENNIAL SURVEY

New strategies, different priorities because of job uncertainty and high home values in major cities

The Royal LePage 2017 cross-Canada survey of Canadians age 25 to 30 revealed:

87%
Believe homeownership is a good investment.

69%
Hope to own a home in the next five years.

61%
Would prefer to buy a detached home.

69%
Cannot afford a home in their region or the type of home they want.

Consequently, many have adjusted their expectations and are open to other property types:

52%
Would look to the suburbs when purchasing a property.

61%
Would be willing to move to another city or suburb where property is more affordable.

TAKEAWAYS

Amid disruptive economic, demographic, political and market forces, the roundtable executives are carefully assessing project yields, monitoring costs, diversifying their portfolios, expanding into new markets and aggressively searching for new opportunities.

MNP recommends developing proactive strategies at four levels can enable Canada's real estate and construction companies to drive growth and value creation while navigating disruption.

Market: Determine opportunities and risks and establish a solid foundation for investment decisions by conducting comprehensive new market assessments.

Portfolio: Identify value gaps by analyzing real estate portfolios, developing benchmarks and measuring performance.

Project: Conduct comprehensive financial due diligence of target investments to assess costs, benefits, affordability, risks and returns.

Operations: Align processes, people and systems to realize optimum efficiency and performance and to support sustainable business growth.

ABOUT MNP

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We play an influential role in diverse industries, particularly the real estate and construction sector. With expertise in markets throughout Canada, we've worked with some of the nation's most successful companies. Our firm invests in building teams and services targeted to helping this important industry thrive.

MNP combines industry expertise, professional insight and innovative approaches to help our clients achieve their goals. We deliver a diverse range of tax, assurance, accounting and advisory services, including business consulting; audit; risk and business continuity; technology; corporate finance; organization, people and change; valuations and litigation support; investigations and forensics and succession planning.

Over 4,200 team members proudly deliver personalized strategies with a local perspective from 70 offices across the country. Our firm is also a member of Praxity, the world's largest accounting alliance, enabling us to support our clients' needs – wherever in the world they do business.

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