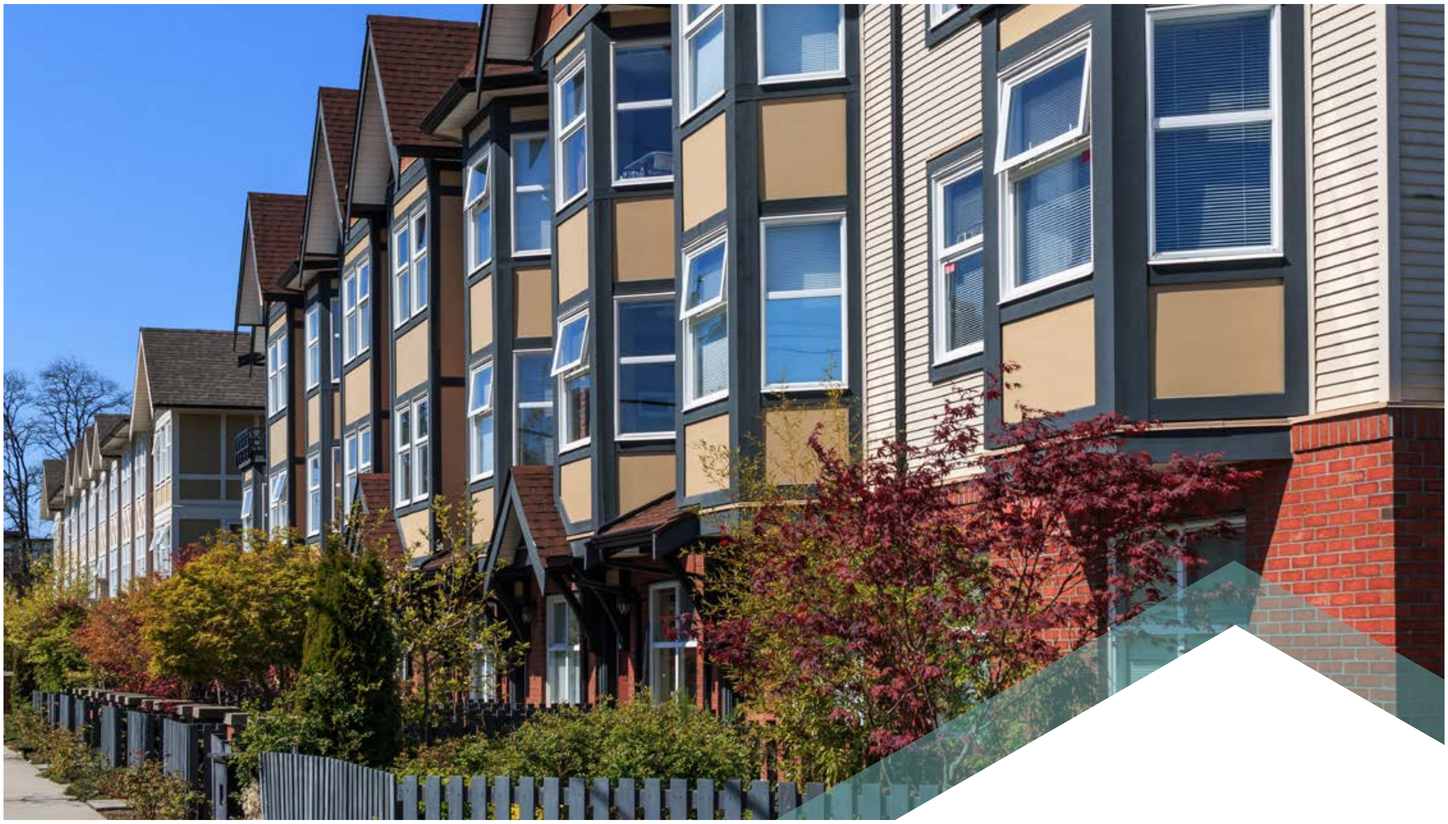

HOUSING RESEARCH REPORT

Constraints on the Supply of New Purpose-Built Rental Projects:

Industry and Investor Perspectives

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Constraints on the Supply of
New Purpose-Built Rental Projects:
Industry and Investor Perspectives

PRISM
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Constraints on the Supply of New Purpose-Built Rental Projects: Industry and Investor Perspectives

Executive Summary

The purpose of this report is to explore constraints on the supply of new, purpose-built rental projects. The report looks at this question primarily through the lens of developers and institutional investors.

The report is based on an abbreviated literature review and 14 interviews with industry stakeholders. Conclusions suggested by the report are necessarily tentative.

The key findings of the report are:

- The approval process for real estate development projects is complex and protracted with uncertain outcomes. Some projects may require 15 or more technical studies as part of the approval process. In some municipalities the approval process may require two years, especially if the project requires, as is common, amendments to an official plan or zoning by-laws.

- The regulatory risk arising from the approval process entails both a 'delay risk' and an 'outcome risk'. The delay risk pertains to the length of time that capital is tied up before the asset will start to generate income. Outcome risk refers to uncertainty about how the approval process will affect the height, density and ultimate cost of a project.

- There are marked differences across municipalities in the time required to obtain construction approval, notwithstanding that municipalities within the same province operate within the framework of the same planning legislation. Local knowledge of approval processes can be an important factor in the ability of prospective developers to navigate regulatory processes. This potentially constrains supply by balkanizing the development industry.

- Site Plan Approval (SPA) is the most complex, delay-prone and uncertain stage of the approval process. By contrast, environmental assessments and construction permits are much less likely to be causes of delay or uncertain outcomes.

- The approval requirements, and the regulatory risk, are essentially the same for purpose-built rental projects and condo projects.

- The interest of institutional investors in acquiring or developing multi-unit rental properties is a significant change in the market;

- There are important differences in the risk profile of condo developers and institutional investors. In particular, institutional investors appear to be more averse to regulatory risk;

- Institutional investors have developed particular strategies for managing regulatory risk. These strategies require collaborations with third parties that variously manage the regulatory process, take on the regulatory risk or diversify exposure to regulatory risk. The availability of these third-parties in particular markets may affect the ability of institutional investors to operate in those markets.

- While regulatory risk is a serious concern to all stakeholders in the property development industry and may reduce investment in every types of housing (condo, rental and freehold), the availability of viably priced land may be a more important constraint on the development of purpose-built rental projects.

Résumé

Le présent rapport a pour but d’examiner les contraintes relatives à l’offre de logements neufs construits expressément pour la location. Cette question est abordée principalement du point de vue des promoteurs et des investisseurs institutionnels.

Le rapport est fondé sur une analyse documentaire abrégée et sur 14 entrevues menées auprès d’intervenants du secteur. Les conclusions du rapport sont nécessairement provisoires.

Voici les principales constatations du rapport :

- Le processus d’approbation des ensembles d’aménagement immobilier est complexe et long, et les résultats sont incertains. Certains ensembles peuvent nécessiter au moins 15 études techniques dans le cadre du processus d’approbation. Dans certaines municipalités, le processus d’approbation peut prendre deux ans, surtout si l’ensemble nécessite, comme c’est souvent le cas, des modifications du plan officiel ou d'un règlement de zonage.

- Le risque de réglementation découlant du processus d’approbation comporte à la fois un « risque de retard » et un « risque de résultat ». Le risque de retard est associé à la période pendant laquelle le capital est immobilisé avant que l’actif commence à générer un revenu. Le risque de résultat fait référence à l’incertitude quant à la façon dont le processus d’approbation influera sur la taille, la densité et le coût final d’un ensemble.

- Il y a des différences marquées entre les municipalités quant au temps requis pour obtenir l'approbation de la construction, même si les municipalités de la même province fonctionnent dans le cadre de la même législation portant sur l'aménagement du territoire. La connaissance des processus d'approbation locaux peut être un facteur important dans la capacité des promoteurs potentiels à composer avec les processus réglementaires. Cela pourrait limiter l'offre en balkanisant le secteur de l'aménagement.

- L'approbation du plan de situation est l'étape la plus complexe, la plus encline aux retards et la plus incertaine du processus d'approbation. En revanche, les évaluations environnementales et les permis de construction sont beaucoup moins susceptibles de causer des retards ou des résultats incertains.

- Les exigences d'approbation et le risque de réglementation sont essentiellement les mêmes pour les ensembles construits expressément pour la location et les ensembles de logements en copropriété.

- L'intérêt des investisseurs institutionnels à acquérir ou à aménager des immeubles collectifs locatifs représente un changement important sur le marché.

- Le profil de risque des promoteurs de logements en copropriété est très différent de celui des investisseurs institutionnels. En particulier, les investisseurs institutionnels semblent plus réfractaires au risque de réglementation.

- Les investisseurs institutionnels ont élaboré des stratégies particulières de gestion du risque de réglementation. Ces stratégies nécessitent une collaboration avec des tiers qui gèrent le processus réglementaire, assument le risque de réglementation ou diversifient l'exposition à ce risque. La présence de ces tiers sur des marchés particuliers peut nuire à la capacité des investisseurs institutionnels à y exercer leurs activités.

- Bien que le risque de réglementation soit une préoccupation importante pour tous les intervenants du secteur de l'aménagement immobilier et qu'il puisse réduire les investissements dans tous les types de logements (logements en copropriété, logements locatifs et logements en propriété absolue), la disponibilité de terrains à prix établis de façon viable peut constituer une contrainte plus importante pour l'aménagement d'ensembles expressément construits pour la location.

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Constraints on the Supply of New Purpose-Built Rental Projects: Industry and Investor Perspectives

Introduction

The purpose of this report is to explore constraints on the supply of new, purpose-built rental projects. The report looks at this question primarily through the lens of developers and institutional investors. The report is based on an abbreviated literature review and 14 interviews with industry stakeholders. Appendix I provides a list of persons interviewed and describes the methodology of the interviews, including the questions used. The interviewees were assured that no comments would be attributed directly to them.

In light of the limited scope of the literature review, the small number of interviews and the fact that only industry stakeholders were interviewed, the conclusions suggested by the report are necessarily tentative.

Literature Review

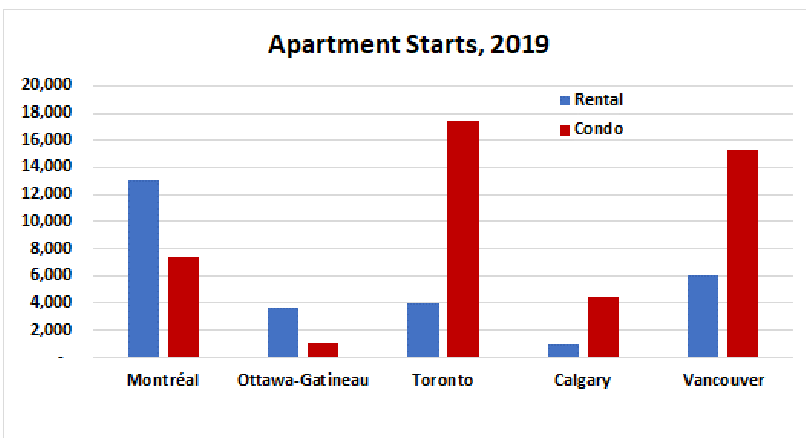
This literature review is *not* a comprehensive scan of the literature on the development approval processes. Its purpose was primarily to inform the framing of interview questions for industry stakeholders. Nevertheless, the literature review does identify themes which may be important in understanding how the approval process for new developments is perceived by different types of industry stakeholders and, in particular, how the approval process may affect stakeholders with different risk profiles.

Some of the studies examined in this literature review were commissioned by industry or advocacy organizations. It should not be inferred, that by summarising the findings or interpretations of these studies, this report is not necessarily endorsing those findings or interpretations.

1. *In many urban centres, the demand for new rental units was primarily met through the secondary rental market, i.e. rented condominiums and secondary suites, not through the development of new, purpose-built rental projects. There is some evidence that this may be changing.*

A report for the City of Vancouver by CitySpaces Consulting (2009) noted that, "since the 1980s, in parallel to the decline of purpose-built rental housing starts, privately owned strata condominiums have played an increasingly important role in the city of Vancouver's rental housing market". Similarly, a study by the Canadian Centre for Economic Analysis (CANCEA) and Canadian Urban Institute found that almost all of the nearly 48,000 new rental households formed from 2011 to 2016 in Toronto were accommodated in the secondary market. In the City of Toronto, purpose-built rental developments accounted for only 6% of the development pipeline from 2011 -2016. There is, however, evidence from reports by market tracking firms that the role of purpose-built rental projects may be increasing. Urban Analytics, for example, noted that in 2018 there were six rental projects initiated in Calgary offering a total of 543 new units. In 2019, this increased to 19 projects offering 2,602 new rental units. A 2019 CitySpaces Consulting report for the City of Vancouver also notes an increase in purpose-built rental projects. Similarly, Urbanation reports that in the GTA, since 2005, only 34 rental projects were undertaken offering a total of 6,723 units. In 2019, however, eight projects were commenced offering 2,458 units and a further 37 projects offering 9,207 were seeking approval. RBC Economics confirms this trend noting a "surge" in rental completions in 2019. RBC notes, however, that there are marked differences across Canada in the sufficiency of new rental supply. This is confirmed by CMHC data on apartment starts by ownership type which show marked differences in the share of rental projects in multi-unit residential starts in 2019

Figure No. 1
Housing Starts for Apartment and Other Types of Units, 2019
Rental vs. Condo



Sources: Statistics Canada, Table 34-10-0148-01
Canada Mortgage and Housing Corporation, Housing starts by type of dwelling and market type

2. *The approval process for real estate development projects is complex and may take significantly longer than in many other comparable jurisdictions.*

   Wood Bull LLP describes the complex site plan approval process that could be required for a notional mixed-use project in downtown Toronto. Wood Bull assumes that the proposed project would require changes in land use from the official plan or the zoning by-law. Among the technical studies that could be required to meet approval criteria are:

   - Appropriate Plans/Drawings
   - Planning Rationale
   - Transportation Impact Study
   - Servicing Report, including stormwater management considerations
   - Arborist/Tree Preservation Report
   - Community Services and Facilities Studies
   - Housing Issues Report
   - Community Benefits if seeking a significant increase in height or density through a rezoning
   - Computer Generated Building Mass Model.
   - Pedestrian Level Wind Study if the proposal is for buildings six storeys (20 metres) or greater in height
   - Sun/Shadow Study if the proposal is for buildings six storeys (20 metres) or greater in height.
   - Loading Study
   - Parking Study
   - Contaminated Site Assessment
   - Natural Heritage Impact Study
   - Environmental Impact Study
   - Archaeological Assessment
   - Heritage Impact Statement

   It is a common assertion in the advocacy literature that approval processes have become more complex and more protracted. Roughly 85% of approval time pertains to site plan approval and related changes to official plans or zoning by-laws, 9% to approvals required by non-municipal agencies (*e.g.*, conservation authorities) and 6% to building permit approval (*i.e.*, compliance with the Building Code). (Green *et al.* 2016).

   The following table from the World Banks report, *Doing Business: Dealing with Construction Permits*, suggests that the approval process for obtaining permission to construct is considerably longer Canada (249 days) than in most other comparable jurisdictions with sizeable urban populations.

Figure No. 2
Time to Obtain Construction Permit – Selected Jurisdictions
World Bank, *Doing Business: Dealing with Construction Permits* (2016).
(Excel Spreadsheet: https://www.doingbusiness.org/en/data/exploretopics/dealing-with-construction-permits)

	Days		Days
Argentina	318.0	Norway	109.5
Slovak Republic	300.0	Japan - Osaka	109.0
Canada - Toronto	**249.0**	Japan	108.0
Slovenia	247.5	Japan - Tokyo	108.0
Czech Republic	246.0	Estonia	103.0
Austria	222.0	China - Beijing	93.0
France	213.0	New Zealand	93.0
Belgium	212.0	United States - New York City	89.0
Israel	200.0	United Kingdom	86.0
Hungary	192.5	Mexico	82.0
Italy	189.5	Taiwan, China	82.0
Ireland	164.0	United States	81.0
Netherlands	161.0	Mexico - Mexico City	76.0
Portugal	160.0	Lithuania	74.0
Switzerland	156.0	Hong Kong SAR, China	69.0
Luxembourg	155.0	United States - Los Angeles	68.0
Spain	147.0	Finland	65.0
Poland	137.0	Denmark	64.0
Germany	126.0	Georgia	63.0
Australia	120.5	Singapore	35.5
Sweden	117.0	Korea, Rep.	27.5
Mexico - Monterrey	112.0		

It needs to be stressed that the measure cited in Figure No. 2 (249 days) may not be representative of approval times in Canada. In the first place, the World Bank's estimate for Canada is based solely on approval times in Toronto. This is unlikely to be a representative indicator of approval time. While the concepts that inform provincial planning legislation are broadly similar, there are nevertheless significant differences in administrative procedures and planning principles. As well, within provinces or territories, approval times for similar projects often differ across municipalities. (See point 3 below). Second, the World Bank's approval time estimate conflates distinct components of the site plan approval process. These include planning approval (conformity with a municipality's land usage plan and zoning bylaws), environmental impact assessment (conformity with provincial environmental legislation) and construction permitting (conformity with Building Code requirements). These are distinct approval processes, not all of which are under municipal control.

3. *There are marked differences across municipalities in the time required to obtain construction approval, notwithstanding that municipalities within the same province are operating within the framework of the same planning legislation. Local knowledge of approval processes can be an important factor in the ability of prospective developers to navigate regulatory processes. If so, those potentially constrains supply by balkanizing the development industry.*

   A survey-based study by Green *et al.* (2015) compared developers' reported approval times for 25 municipalities in the Greater Golden Horseshoe area of Ontario. The study found marked differences. The median approval time was 17.5 months, the lowest 13.8 months and the highest 28.0 months. The length of the approval process time did not correlate with the size of the municipality. Toronto had among the lowest approval times (15.9 months). The approval times reported by Green *et al.* are roughly double the time reported in the World Bank study.

   A study by RealPac also found marked differences in approval times. RealPac estimates that Vancouver had average processing times of 4-6 months for zoning by-law amendments, while Toronto averaged more than 12 months.

   The Ryerson University Centre for Urban Research and Land Development asserts that the complexity of approval processes confers an advantage on property developers that have local knowledge of the approval process and contacts that may enable them to expedite approval. This potentially has the effect of balkanizing the property development market such that it comes to be dominated by local suppliers, thereby reducing capacity and constraining supply.

4. *Longer approval times can have a negative impact on the growth of housing supply.*

   A 2016 study by Green *et al.* (2016) finds that "increasing the average approval timeline for residential development by six months is associated with a decrease in growth of 3.7 percentage points—equivalent to halving growth of the average neighbourhood in our data." They further comment that "[their] data suggest that moving from the average city's approval timelines or perceived timeline uncertainty to a higher level (one standard deviation above average) is sufficient to mute completely the responsiveness of the housing supply to demand in desirable neighbourhoods".

5. *Variances from official plans or amendments to zoning by-laws are the norm, not the exception, in major real estate development projects. This requirement potentially introduces both lengthy delays and uncertainty as to the ultimate outcome of a development application.*

   Some developers of multi-unit projects may acquire land that is already suitably zoned and propose a project that fully conforms with a municipality's official land use plan. However, this does not appear to be the norm. The majority of large projects appear to require rezoning or some other variance from the official plan, often including greater density. A study by Shahi *et al.* of 174 tower projects in Toronto (both residential and commercial) between 2008 and 2016 found that over 80% of the projects required re-zoning. Most of these proposals were referred to the Ontario Municipal

Board when the City either failed to respond to the request for re-zoning or rejected the request.[1] The Association of Municipalities of Ontario (AMO) examined cases referred to the Ontario Municipal Board (OMB) between 2013 and 2105. (At the time of the AMO study, the OMB was the appeal body for parties who wished to challenge a municipal policy or decision. The OMB has since been replaced by the Local Planning Appeal Tribunal. Figure No. 3 summarizes the types of cases referred to the OMB:

Figure No. 3
Categorization of Appeals to the Ontario Municipal Board (OMB), 2013-2015
Association of Municipalities of Ontario (AMO),
"Ontario Municipal Board Reform: Maturing Roles Discussion Paper (June 2016),
Figure No. 2, p 6

Type of Appeal	No. of Appeals	Percent of Total
Zoning By-law/Amendment	1,623	29.5%
Plan of Condo/Subdivision	220	4.0%
Official Plan/Amendment	1,263	23.0%
Minor Variance	1,715	31.2%
Consent to Sever	677	12.3%
Total	5,498	100.0%

As can be seen from Figure No. 2, 60.7% of applications dealt with changes to zoning by-laws or official plans. This is broadly consistent with Shahi's findings and indicates that the site plan approval phase of the municipal approval process is the key source of both delay and uncertainty of outcome.

6. *The causes of delay in the site plan approval process are complex. The cumulative effect on application processing times of multiple requirements can be significant. In addition to municipal requirements, other sources of delay may include: protracted appeal processes initiated by residents who oppose a development, lack of familiarity with approval requirements and processes on the part of developers, environmental assessments required by provincial authorities, and the need for additional infrastructure to support a development.*

Opposition to large projects by local residents, sometimes with the support of a local government, is a common occurrence. A report by Affordability and Choice Today comments that "the "Not in My Backyard" (NIMBY) phenomenon may not be new, but its more recent expression has become a special challenge in the development process." This view is echoed by the Association of Urban Municipalities of Alberta (AUMA) and by the Association of Municipalities of Ontario (January 2019). Local residents who oppose a development may use appeal procedures to draw out the approval process in the hope that the passage of time will force the project to be abandoned or a change in

[1] En vertu de l'ancienne *Loi sur l'aménagement du territoire*, un promoteur pouvait interjeter appel d'un rejet ou d'un retard dans le processus d'approbation auprès de la Commission des affaires municipales de l'Ontario, dont la décision allait à l'encontre du conseil municipal local.

political leadership will be more sympathetic to the residents' objections. AMO (January 2019) suggests that legislative steps to rein in NIMBYism are needed.

Fenn notes that the "cumulative or aggregate impact of regulation is often not fully appreciated" by governments. He describes successful pilot projects in five Ontario communities to reduce processing time for various business approvals, including development projects. These include providing 'sherpas' to guide developers through a municipal approval process, adopting client-centred practices from the business sector, re-engineering procedures to reduce processing times, and focusing regulatory resources on the issues which are mostly likely to be problematic. Fenn also recommends delegating approval authority in some areas to licensed professional who would be hired by project proponents.

Two studies by the Residential Construction Council of Ontario (RESCON) also suggest changes that would reduce the time required for site plan approval and the uncertainty associated with approval applications.

The Association of Municipalities of Ontario (AMO) (August 2019) notes that a shortage of adjudicators to hear appeals to the Local Planning Appeal Tribunal (formerly the Ontario Municipal Board) also adds to delays as does the right of applicants to introduce evidence not previously presented to the municipality whose decision (or lack of decision) is being challenged. AMO (January 2019) also notes some residential developments require large infrastructure upgrades, such as water or wastewater services, that may require approval by a senior level of government. This can contribute to delays.

7. *There is no assertion in the literature that the approval process for purpose-built rental projects differs from the approval process for a condo development of comparable size.*

   Reports on municipal approval processes, even when critical, make no assertion that the approval process for purpose-built rental projects differs in any material way from the approval process for a condo project or a commercial project of comparable size. (RESCON, Wood Bull).

8. *Investment in multi-unit residential projects appears to be sensitive to incentive schemes. In some urban centres, the economics of purpose-built rental projects may be intrinsically unattractive in the absence of incentives.*

   CitySpaces Consulting (2019) concludes in a study for the City of Vancouver that incentives had a positive effect on the construction of purpose-built rental projects. A study by Ryerson University's School of Urban and Regional Planning suggests a range of incentives to encourage construction of purpose-built rental projects. The study stresses the need for regionally-tailored incentives as opposed to 'one size fits all' programs.

   Numerous commentators refer to the Multi-Unit Residential Building (MURB) incentive which operated from 1974 to 1981. Under the MURB incentive, development costs were aggregated and assigned to investors on a unit-by-unit basis. These costs could then be deducted against other income unrelated to the development project. In the absence of the MURB scheme, development would be amortized and expensed over the life of the project. (Steele). The Coriolis Consulting Group comments that the winding down of the MURB incentive was associated with a marked deceleration of investment in purpose-built rental projects. Some commentators, however, question whether the MURB incentive was effective (Wicks, LandlordBC).

Two studies suggest that, in some urban centres, purpose-built rental projects may not be financially feasible. An Altus Group study for the Canada Mortgage and Housing Corporation found that "cash-on-cash returns on the private rental apartment building developments modelled were typically negative—even if land cost was assumed to be zero". A similar finding is reported for Vancouver in a study by the Coriolis Consulting Group. The contrast is with condo projects. Investors in condo units may be willing to absorb a cash-flow loss (*i.e*., rents below carrying costs) because they intend to reap a capital gain by selling the unit after several years. By contrast, investors in purpose-built rental projects generally require a positive cash-flow from commencement of occupancy.

Interviews

Three themes were raised by a large majority of the interviewees. The first is the complex and protracted nature of the site plan approval process for applications to develop a multi-unit residential building and, more importantly, the uncertainty about how the approval process will affect the timing and configuration (density, height and cost) of a project. The second is the increased interest of institutional investors - chiefly pension funds and real estate investment trusts (REITs) - in acquiring equity positions in both new and existing rental projects. The third is the different risk profiles of condo developers and institutional investors, how these differences relate to regulatory risk and the potential implications for expanding the rental sector.

Regulatory Risk

The approval process for applications to develop a multi-unit residential project entails two types of regulatory risk. The first is 'delay risk' which arises from the time required to complete the various technical reports required for approval. Sensitivity to delay risk is chiefly determined by the amount of capital at risk and the exposure to higher construction costs that delay may entail. The second type of regulatory risk is 'outcome risk'. This arises from uncertainty about the decisions that local authorities will ultimately make on the permitted height and number of units in the project and the required amenities (*e.g*., parking) and community benefits. This uncertainty is increased if the project requires amendments to a municipality's official land usage plan or zoning by-laws. The uncertainty of outcome is further increased if a dispute with the municipality leads to an adjudication process. The need for amendments to official plans or by-laws and adjudication also increase delay risk. The perception of regulatory risk is influenced by a developer's history with a municipality and its prior experience in managing this risk.

Stages of Development

The stages of development can be captioned as follows:

1. Pre-Approval Stages
    a. Land Acquisition
    b. Financing
2. Approval Stages
    a. Site Plan Approval
        i. Height, Density and Use:
            1. Planning Rationale
            2. Community Consultation
            3. Community Benefits Negotiations (where applicable)
            4. Potential Zoning By-Laws/Official Plan Amendments
        ii. Various Technical Studies (depending on site), most to be prepared by a regulated professional in the field, such as a Professional Engineer, Geoscientist, Arborist, *etc*.
            1. Servicing Study (water, stormwater, etc.)
            2. Hydrogeological Study
            3. Geotechnical Study
            4. Transportation, Parking, Loading Impacts
            5. Wind Study (wind tunnel effect)
            6. Sun/Shadow Study
            7. Noise Study
            8. Energy Use Study
            9. Tree Preservation/Replacement Plan
            10. Green Building Standards (where applicable)
        iii. Environmental Impact Assessment
        iv. Heritage Assessment / Archeological Assessment
3. Construction Stage
        i. Permits (compliance with Building Code)
        ii. Work-in-Progress Inspections
        iii. Pre-Occupancy Inspection

Pre-Approval Stages

Although the focus of this report is on developers' perspectives on the approval process, several interviewees offered comments on pre-approval stages and their importance as potential constraints on expanding the purpose-built rental sector.

Land Acquisition

Several interviewees commented that, in the markets in which they operate, there is a shortage of land that is available for high or mid-density development. A majority of interviewees also believed that the return on invested capital is markedly higher for condo development compared with purpose-built rental projects. If this is the case, a potentially important consequence of the higher profitability of condo projects is that condo developers can out-bid rental developers for the same tract of land. Three interviewees made this point. They suggested that, in the markets in which they operate, land shortages are the single most important constraint on expanding the purpose-built rental sector.

Financing

Several interviewees noted that condo projects require substantially less capital-at-risk than purpose-built rental projects. A condo developer's capital costs are: the cost of land up to the amount required to obtain a first mortgage and the project's 'soft costs'. The soft costs are chiefly: (a) the costs associated with design, (b) the cost of technical studies and legal representation associated with the approval process, (c) marketing costs for the finished project. Lenders will typically finance construction costs after 80% of the units are pre-sold. Purchaser's deposits contribute to financing the portion of construction that is not financed by a construction loan. Overall, condo developers have capital-at-risk that is equal to approximately 20% of the project's value. They can expect to fully re-coup their capital and realize their gain within five to six years, following acquisition of the land.

For a project of comparable size, a purpose-built rental project would require a much greater amount of capital-at-risk and also would tie up that capital for a much longer period of time. Four interviewees suggested that lenders generally require a much greater equity ratio (compared to condos) before extending a construction loan and also will require close to 90% occupancy before extending a first mortgage. Three interviewees suggested that because rental developers have substantially more capital at risk, they are more concerned (than condo developers) about both delay and certainty of outcome in the regulatory process. Two interviewees suggested that, for this reason, some institutional investors favour existing rental buildings over new projects since investments in the former do not entail any regulatory risk.

Approval Stages

The chief components of the approval stage are site plan approval or SPA and construction approval. SPA is, by far, the most time-intensive stage of the approval process. The majority of interviewees indicated that SPA requires two to three years. By contrast, interviewees with direct development experience did not regard the approval times for construction permits or the scheduling of subsequent inspections to be a major cause of delay. All interviewees agreed that the approval processes are essentially the same for condo projects and for purpose-built rental projects.

Site Plan Approval (SPA)

Virtually all interviewees commented that *there are no material differences in the site plan approval process between condo projects and purpose-built rental projects*. In general, all approval requirements are the same irrespective of the building's use. In fact, projects may undergo a change in status from condo to rental (or the reverse) during the approval process with no impact on the approval process. It was suggested by two interviewees that some municipal governments will expedite approval of a rental project, especially if the project incorporates affordable units. That being said, *interviewees stressed the complexity of the site approval process and the delays and uncertainty as to outcome that are associated with it*.

(a) Height, Density and Use Approval

Official plans set out the approved height, density and use (commercial, residential, industrial, *etc*.) that are permitted for buildings in various areas of a municipality. Zoning by-laws may add additional restrictions or requirements although, in principle, these should be consistent with the official plan. The rationale for a project must demonstrate that it is consistent with the principles reflected in the official plan, the zoning by-laws and relevant municipal or provincial policies. Several interviewees commented that, in the municipalities in which they have operated, it is common for proponents of multi-unit residential projects (condo or rental) to seek a variance from the official plan and/or the relevant zoning by-law. The time to obtain such a variance was described as a significant source of delay.

In Ontario, a number of interviewees commented that the former sec. 37 of the *Planning Act* encouraged applications for variances from the official plan by allowing a municipality to grant height or density bonuses in exchange for negotiated community benefits to be provided by the developer. This introduced an element of uncertainty about the ultimate configuration of a project and its cost. The provincial government has since repealed the sec. 37 'bonus' provisions and replaced them with development charges. Two interviewees commented that this could reduce uncertainty about permissible height and density, as well as cost.

Two interviewees noted that community consultations require time and must be well managed to avoid triggering local opposition which can lead to a more protracted approval process, including potentially appeals to adjudicative bodies.

(b) Required Technical Studies

The SPA process requires a range of technical studies. One interviewee noted that most of these must be prepared by a licensed professional, such as an engineer. The number and the scope of technical studies varies depending on both the municipality and the specific site. One interviewee provided a list of studies and submissions required for a currently under-way mid-rise project in the City of Toronto:

1. Planning and Urban Design Rationale, including a Scoped Avenue Segment Study and a Community Services & Facilities Inventory
2. Sun/Shadow Study
3. Pedestrian Level Wind Study
4. Phase One Environmental Site Assessment
5. Stage One Archaeological Assessment
6. Toronto Green Development Standards Checklist
7. Hydrogeological Study
8. Geotechnical Study
9. Traffic Impact Study
10. Functional Servicing and Stormwater Management Report
11. Tree Inventory and Arborist Report

12. Building Massing Model
13. Public Consultation Plan
14. Energy Strategy
15. Noise Study

Three interviewees commented that there are marked differences across municipalities in the requirements for site plan approval, the time required, the costs incurred for expert studies and the likelihood of requiring adjudication to resolve site plan disputes. One interviewee that operated in more than one province commented that the differences between municipalities in the same province can be much greater than the differences in provincial planning frameworks.

One interviewee noted that experienced developers are aware of the requirements for expert reports and are able to initiate these studies concurrently so as to reduce the submission time. However, some reports (e.g., sun/shadow study and traffic impact study) can only be finalized when the configuration of the building (height and density) is settled. It was noted by one interviewee that all technical reports are scrutinized in detail by city officials without regard to the city's past experience with the professional that prepared the report. The sufficiency of city resources, it was noted, can be a bottleneck.

(c) Environmental Impact Assessment

None of the interviewees identified Environmental Impact Assessments as a source of significant delay. These assessments, it was noted, are provincial requirements. One interviewee commented that there is a large pool of professionals who prepare these reports and also an internationally recognized standard (ASTM E1527-13).

(d) Heritage Assessment / Archeological Assessment

Heritage or archeological assessments are required by provincial legislation, although approval is usually delegated to municipalities. Provincial requirements may be augmented by specific municipal requirements. The impact assessments may require modifications to the planned project to preserve certain pre-existing features. None of the interviewees identified a Heritage/Archeological assessment as a major source of delay.

Construction Stage

The construction process requires one to three years, depending on the scale and complexity of the project and labour supply conditions in the local market. In recent years, construction costs (both labour and materials) have been more unstable. This has introduced a greater degree of construction cost risk arising from unexpected approval delays. Two interviewees noted that, for condo developers, this risk is particularly important as upwards of 80% of the units in a project are pre-sold. Condo developers have limited ability to pass on unexpected cost increases. Construction cost risk, it was suggested by one interviewee, is less of a consideration for rental project developers as the cost increases will ultimately be reflected in rents assuming that the market can bear the rents required for the project to be profitable.

None of the interviewees considered Building Code approvals or work-in-progress inspections to be a significant source of delay. It was noted by one interviewee that innovative design strategies can delay permitting. Building Codes prescribe the characteristics required in a building component but also allow for innovative design solutions that meet the same performance standards as the prescribed characteristics. The developer must provide engineering or architectural reports attesting that the Code's performance requirements will be met by the innovative design strategy. Large municipalities, it was suggested, have the technical capacity to evaluate innovative strategies. However, smaller municipalities may lack this capacity. This can contribute to delay.

Institutional Investment in Purpose-Built Rental Properties

Previously, it was suggested by several interviewees, that purpose-built rental projects were almost always undertaken by private developers. Several interviewees commented on how this picture has changed. Some Real Estate Investment Trusts (REITs) now have a specific mandate to acquire rental existing properties or to invest in new projects. Equally important is the interest of institutional investors (chiefly pension funds) in altering their real estate portfolios to include more rental properties and warehouses ('beds and sheds', as described by one interviewee). A potentially important implication of this change in the market is that programs to accelerate investment in purpose-built rental projects may need to take account of the specific needs of non-taxable institutional investors, such as pension funds, and 'flow-through' entities such as REITs. These types of investors may be less motivated by tax incentives, but much more sensitive to reductions in regulatory risk owing to the nature of their risk profile.

Condo Developers vs. Institutional Investors: Differences in Risk Profiles

Interviewees noted three differences in the risk profiles of condo developers and institutional investors. First, for projects of comparable size, institutional investors have more capital at risk. Consequently, institutional investors are more sensitive to delay risk which can result in higher construction costs and outcome risk which can have an impact on expected net operating income. It was suggested by one interviewee that some institutional investors could regard an unapproved rental project as speculative. A second factor of importance that was noted by three interviewees is that while condo investors often have experience with local approval processes, institutional investors frequently do not. Institutional investors, therefore, may have less ability to gauge the magnitude of delay risk or outcome risk. Prudence could lead them to be overly cautious in estimating regulatory risk. Finally, condo developers tend to be specialized. At any time, they may have only one or a few projects under way. By contrast, it was noted by two interviewees that institutional investors apply diversification principles whenever possible. They prefer to spread their risk exposure over a pool of projects, rather than confine that risk to a single project. Similarly, institutional investors often prefer to participate in investment consortia rather than take a 100% stake in a single project. These differences in risk profiles, especially in the sensitivity to regulatory risk, are relevant to understanding how regulatory processes can affect the flow of investment into the rental sector.

Institutional Investors' Strategies for Managing Regulatory Risk

To manage the regulatory risk associated with investing in new, multi-unit rental projects, institutional investors commonly turn to one of three strategies. The first is to use a forward-purchase contract with a third party. This third party develops and then markets the rental project. After the project achieves a high occupancy rate (usually 90%), the institutional investor assumes ownership of the building at a pre-agreed price. A second strategy used by institutional investors is to invest alongside trusted partners who have experience in managing regulatory risk. In these circumstances, the institutional investor would have less than a 100% stake in the project. A third strategy is to take an equity position in a fund that is managed by an experienced third-party. This third party develops, markets and manages a portfolio of rental projects. Interviewees suggested that the first and second approach is generally preferred by large institutional investors. The third approach is preferred by smaller institutional investors. In some regions, it was noted by one interviewee, there may be an undersupply of third-party firms that can undertake the rental project development process and therefore manage regulatory risk for institutional developers.

New Builds vs. Existing Projects

For some institutional investors, the alternative to investing in a newly constructed rental project is to purchase an existing building. There are both advantages and disadvantages to investing in an existing building. The most compelling advantages are that there is no regulatory risk and the building's net operating income is a known value. However, one interviewee suggested that some institutional investors are sceptical of existing buildings because they do not have confidence in the quality of the initial construction and therefore cannot reliably assess the long-term maintenance risk. Nevertheless, purchasing an existing building, with established tenancies, is clearly attractive. It was suggested by one interviewee that when existing rental buildings are put on the market, 'there is a line up to buy them'.

It was suggested that the market valuation of regulatory risk can be inferred from the difference in the capitalization rates ('cap rates') used by the purchaser of an existing rental building and by an investor in a new rental project where the two buildings are comparable. The cap rate is the ratio of net operating income to asset value.

A cap rate of 5% therefore implies an asset value that is twenty times the net operating income. Currently in some markets the cap rate for a newly constructed building is 5% whereas for an approximately equivalent existing building, with a comparable expected net operating income, the cap rate is 4%. This implies that, in these markets, institutional investors are prepared to pay around 25% more for an existing building to avoid regulatory risk.

Importance of Land Costs to the Financial Viability of Rental Projects

Four interviewees commented that a purpose-built rental project is expected to generate a net return to the investor from the point at which it achieves near-full occupancy. In some markets, this is not feasible unless the land was purchased at a much lower cost that current market conditions would dictate. This is sometimes the case when land that housed retail malls is converted to residential use. Real Estate Investment Trusts (REITs) that were major investors in mall assets therefore have been able to transition into mixed use developers with a component of rental buildings because they are able to avoid high land costs. One interviewee commented that, in Toronto, at current land prices, prospective developers of rental projects cannot compete with condo developers.

Tax Issues

One interview raised the issue of how development charges are structured. These are levies imposed on a new project to cover the costs to a municipality of providing infrastructural services. In some jurisdictions, development charges on multi-unit residential projects are based on the number of bedrooms. A typical condo project, it is suggested, will have fewer bedrooms per 1,000 sq. feet of construction than a rental project. Hence a rental project would pay a higher overall development charge than a condo even though the total floor space in the two building is identical.

Summary

The most important conclusions to be drawn from the literature and from stakeholder interviews are:

First: approval processes for property development projects are complex and protracted. The regulatory risk arising from the approval process entails both a delay risk and an outcome risk. The delay risk pertains to the length of time that capital is tied up before the asset will start to generate income. Outcome risk refers to uncertainty about how the approval process will affect the height, density and ultimate cost of a project. The site plan approval (SPA) stage of the approval process is the principal source of regulatory risk;

Second: the approval requirements, and the regulatory risk, are essentially the same for purpose-built rental projects and condo projects;

Third: the interest of institutional investors in acquiring or developing multi-unit rental properties is a significant change in the market;

Fourth: there are important differences in the risk profile of condo developers and institutional investors. In particular, institutional investors appear to be more averse to regulatory risk;

Fifth: institutional investors have developed particular strategies for managing regulatory risk. These strategies require collaborations with third parties that variously manage the regulatory process, take on the regulatory risk or diversify exposure to regulatory risk. The availability of these third-parties in particular markets may affect the ability of institutional investors to operate in those markets.

Sixth while regulatory risk is a serious concern to all stakeholders in the property development industry and may reduce investment in every types of housing (condo, rental and freehold), the availability of viably priced land nevertheless may be a more important constraint on the development of purpose-built rental projects.

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Appendix I

List of Interviewees

John Bartkiw
Managing Director
Fengate Asset Management
Toronto, ON

Eric Burchill
Vice-President
Southwest Properties
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Rupert Campbell,
Director of Development & Acquisitions
Cape Group
Vancouver, B.C.

Rob Douglas
Managing Director

Kevin Taylor
Portfolio Manager – Real Estate Group

Umair Raza, CFA, MBA
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Alexandre Godbout
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Ronald M. Kanter
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Scott McLellan
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Plaza Corp.
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Glen MacMullin
Chief Investment Officer.
Minto Apartment REIT
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Steve Nightingale,
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Oxford Properties Group
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Ronald Struys
Real Estate and Finance Consultant
Sales Representative
Re.Max / Hallmark Realty
Toronto, ON

Jeff Thomas
Group Head, Development
KingSett Capital
Toronto, ON

David Waldref
Senior Vice-President
Wesgroup Properties
Vancouver, BC

Interview Questions

1. What accounts for the low levels of purpose-built rental housing in the past twenty years or more? How important were rent controls? Has the removal/weakening of rent controls reduced/eliminated developers concerns about the policy environment?

2. What proportion of buyers of new condos today would you estimate are investors?

3. If you operate in an area subject to a foreign buyers' tax, what impact if any has the tax had on the supply and demand of condos and rental units?

4. Are there any differences in the attitudes of local communities (*e*.g., ratepayer associations) to condo projects and purpose-built rental projects that favour condo developments over purpose-built rental projects or vice versa?

5. Are there any differences in the regulatory approval process between condo projects and purpose-built rental projects that favour condo developments over purpose-built rental projects or vice versa?

6. In the cities in which you have undertaken either condo or purpose-built rental developments, what has been the approximate time required for the approval process? What stage or requirement of the approval process tends to be the most time-consuming?

7. Municipalities differ in their approval process. However, certain common approval stages often apply. Can you comment on the degree to which the following or other stages of approval may hinder the development of purpose-built rental projects:

    a) Site Plan Approval
    b) Community Consultation
    c) Building Code Approval and Subsequent Inspections
    d) Other

8. In general, do high-rise development projects typically require an application for re-zoning, a variance from zoning requirements or an increase in density above that permitted by a municipality's official plan?

9. Approval requirements differ in their complexity depending on the municipality and the nature of the project. The following is a list of studies required for a medium-sized project in Toronto. How representative is this list? What challenges do these requirements pose? Are there any challenges that would be unique to a purpose-built rental project? Are there other studies that might be required?

a) Planning and Urban Design Rationale
b) Draft Zoning By-law Amendments
c) Sun/Shadow Study–
d) Pedestrian Level Wind Study
e) Phase One Environmental Site Assessment
f) Stage One Archaeological Assessment
g) Toronto Green Development Standards Checklist (Toronto Only)
h) Hydrogeological Study
i) Geotechnical Study
j) Traffic Impact Study
k) Functional Servicing & Stormwater Management Report
l) Tree Inventory and Arborist Report
m) Building Massing Model
n) Public Consultation Plan
o) Energy Strategy
p) Noise Study

10. Are there any differences in building code requirements between condo projects and purpose-built rental projects that favour condo developments over purpose-built rental projects, or vice versa?

11. Are there any differences in property taxes (mill rates) between condo projects and purpose-built rental projects that favour condo developments over purpose-built rental projects, or vice versa?

12. Are there any differences in the application of GST/HST between condo projects and purpose-built rental projects that favour condo developments over purpose-built rental projects, or vice versa?

13. Are there any other federal or provincial policies that might favour condo developments over purpose-built rental projects, or vice versa?

14. Are there any municipal programs that favour condo development over purpose-built rental projects, or vice versa?

15. Are there any differences in access to financing between condo projects and purpose-built rental projects that favour condo developments over purpose-built rental projects or vice versa? What is the benchmark for getting a construction loan for a purpose-built rental project versus a condo project?

16. In your experience, for investors in new condo units, would the expected rental income typically cover the investor’s mortgage carrying costs and condo fees?

17. Has the increasing use of short-term rentals impacted condo or rental markets in which you operate and if so, how?

18. Have you seen an increase in institutional investors' (pension funds, life insurance, REITs) interest in purpose-built rental projects? Is this interest focused more on existing projects or on new-builds?

19. It has been suggested that institutional investors are reluctant to invest in a development project until it has received all necessary approvals. Is this your experience?

20. Have you seen any innovative approaches that better align institutional investors and rental unit developers?

Interview Methodology

- The questions were provided to the interviewees in advance of the interview.
- Twelve (12) interviews were conducted by telephone; two (2) interviews were conducted face-to-face.
- Interviewees were assured that in the final report, no comments would be specifically attributed to them.
- Each interview took 20-30 minutes.
- Interviews were not recorded.
- Seven interviews were conducted jointly by two interviewers. Seven interviews were conducted by a single interviewer.
- In some cases, more than one interviewee participated in the interview session.
- Notes were taken by each interviewer. When more than one interviewer took notes, these were combined into a single interview report.
- The content of the 14 interview reports was then organized thematically.
- Where necessary, points raised in an interview were clarified by an exchange of emails.
- In addition to the interviews, the authors of the report also participated in an information webinar conducted by a specialist on rental development.

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