Mortgage changes and tenant demand spur landlords

COVER | Low-cost financing, insatiable tenant demand – and a perception of safety – enough to keep local investors jumping into Canada's most expensive multi-family rental market

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In Metro Vancouver's rental apartment game, capitalization rates are shrinking, input costs are soaring, aging suites are being sold for more than $1 million and construction costs are rising faster than anywhere in the country.

Yet, real estate agents say, list the right apartment building in the right area and two dozen investors will be lining up at the door.

The prices are shocking even by Vancouver standards. A 60-year old, 12-suite apartment building near the **University of B.C.** sold this year for $1.1 million per door – and it is considered bulldozer bait, according to **John Gee**, vice-president of **Colliers International**. "I would guess that that building will be coming down in a year or two, or sooner," Gee said.

In Kitsilano, **NAI Commercial** sold an aging, eight-unit apartment building on Cornwall Avenue for $628,125 per suite. The capitalization rate is a skinny 3 per cent, according to **Terry Harding** of NAI. Harding said NAI recently sold an even older, 20-unit rental building on Cornwall Avenue for $425,000 per door and a nine-unit rental building on Point Grey Road "that needed a complete renovation" for $588,000 per suite. NAI just closed on a 14-unit building in New Westminster at $140,000 per door, which Harding said is high for that market.

Last year 93 apartment buildings sold in Metro Vancouver, down slightly from a year earlier, according to a study by **HQ Commercial**. The average price paid in 2013 was $11.8 million per building. Sales continue to track down this year, but Harding argues that the only reason sales have slowed is "no one needs to sell. The only time you see a listing is when an owner wants to retire."

Lance Coulson of **CBRE National Apartment Group**, agrees. "There is a lack of quality product," said Coulson.

"There is a lot of money chasing very few deals."

But even seasoned agents acknowledge the mathematics for investing in Vancouver rental buildings seem screwy, despite a tight 2 per cent vacancy rate.

Cap rates are around 3 per cent to 3.5 per cent, the lowest for any commercial property sector, and the costs of hydro, property taxes and other charges are increasing three or four times faster than B.C.'s legislated annual rental increase, which this year is 2.2 per cent.

Lance Coulson of CBRE's National Apartment Group: "There is a lack of quality product. There is a lot of money chasing very few deals." | RICHARD LAM

> *Costs are increasing at a rate higher than the annual allowable rent*
>
> JEREMY BRAMWELL OF BRAMWELL & ASSOCIATES REALTY

High input costs

A survey of apartment building expenses, done by appraiser **Jeremy Bramwell** of **Bramwell & Associates Realty**, found operating costs in the Lower Mainland average 53.6 per cent of rents and other cash that properties generate for owners, through such items as parking and laundry. The biggest expenses are repairs and maintenance (11.8 per cent), property taxes (6.75 per cent) and non-resident staff (6.2 per cent), followed by utilities (5.7 per cent).

"Costs are increasing at a rate higher than the annual allowable rent," Bramwell said. "It's slowly beginning to push the [net operating income] to a point where it's less than 50 per cent of the income for the property."

Rising expenses without a commensurate increase in income can have a significant effect on valuations, Bramwell said, especially when cap rates – an indicator of the return a property promises investors – are low.

"When you're down to between 3 per cent and 4 per cent on a cap rate, a couple of thousand dollars' change in expenses without any adjustment in the income can start to have a rippling effect to the capital value," Bramwell said.

Low caps, Coulson said, are a likely reason why large institutional investors, such as real estate investment trusts and pension funds, are bypassing Vancouver. "It is harder to acquire the needed mass or the returns" here as compared to Alberta, which has no rent controls, or Toronto, he said.

Some big players have apparently just given up on B.C, or least the bigger centres.

Calgary-based **Boardwalk Real Estate Investment Trust**, one of Canada's largest landlords, has

Mark and David Goodman of HQ Commercial: Recent buyer resistance due to "fatigue" with high prices and low returns. | RICHARD LAM

listed all three of its concrete rental buildings – in Surrey, Burnaby and Victoria with a total of 637 suites – and is now accepting bids, according to Coulson. "[The large investors] want to be here, but the numbers often don't work," he said.

Mark Goodman of HQ Commercial said the Metro Vancouver market is now and always has been dominated by domestic investors. "The same 25 or so people come out to every Vancouver listing we get," Goodman said. He explained these are divided into two distinct groups: "the buy-and-holders and the value- adders." The former strategy is to seek secure parking for cash, despite the low cap rates. The latter are those who rely on buying an older property, renovating it and counting on a lift in both rental income and appreciation.

"The lifts can be substantial," Goodman said. In B.C., rents can be raised to market level – often well above the legislated rent increases – with a tenant turnover, which is often part of the value-added strategy.

Still, Goodman said he is recently seeing "resistance" in the market and expects apartment building sales to plateau this year. "There is fatigue with the high prices and the low caps," he said.

Cheap financing

Buyers of apartment buildings have one big advantage: low-cost mortgage money through **Canada Mortgage and Housing Corp**. (CMHC) insured mortgages.

Recent changes to CMHC mortgages that reduced the ability of small investors to buy rental condos have not affected apartment building buyers, who deal with commercial mortgages. In one recent deal, the buyer of a Kitsilano apartment building acquired a $1.9 million CMHC-insured mortgage for five years at 2.45 per cent. Ten-year terms are available as low as 3.3 per cent, well below conventional long-term residential mortgage rates for rental investors.

Purpose-built

There has been plenty of buzz in Metro Vancouver about the potential of purpose-built rental apartments, but it has not translated yet into many new units.

The **City of Vancouver** approved a record 1,097 rental units in 2013, surpassing the previous record of 1,021 in 2012 and prompting Vancouver Mayor **Gregor Robertson** to tout the success of his rental stimulation programs, which provide city incentives.

Other factors, however, include higher costs of buying rental buildings compared with building new ones and consumer demand for higher-end suites.

"If we want to grow in this market and we don't want to buy small, 30-unit, wood-frame buildings and we don't want to buy buildings above replacement cost, we really have no choice but to build," said **Hollyburn Properties Ltd**. vice-president **Daniel Sander**.

But Goodman said that if you look closely, there are a lot more plans to build rentals than are actually breaking ground. He helped **Altus Group** compare the cost of building new against buying an older apartment building. The bottom line is that the returns on a new build are not much better, especially in a market that has the fastest-rising construction costs in the country.

Construction prices for apartment buildings in Metro Vancouver increased 3.2 per cent in the past year, according to **Statistics Canada** data released May 13, the highest growth in Canada.

Michael Deighton, vice-president of acquisitions at **Bosa Properties Inc.**, confirmed that his company is starting to get interested in owning rental properties. But he added that it's not a get-rich-quick proposition.

"If you take a long-term enough approach to it, like we do, you start to see the light at the end of the tunnel at about 15 years."

$1.1 million a door: That's what a buyer paid in March for this half-century-old, 12-unit rental building on Vancouver's West Side | COLLIERS INTERNATIONAL.

Developers are keen to build smaller apartments because the per-square-foot rental income is much higher for studio and one-bedroom suites than it is for larger units.

The downside of a proliferation of smaller units is that it makes it impossible for families to find appropriate units, said **Brian Jackson**, City of Vancouver general manager of planning. "In the past we haven't pushed for the rental projects to have a higher number of two-bedroom units, but we're certainly doing this now," he said.

Vancouver has 63 rental projects in various stages of development. Most units in those projects are smaller, but Jackson said the city has made recent strides to include larger units.

For example, he pointed out that half of the 290 social housing units at the Oakridge Centre redevelopment will be either two- or three-bedroom.

But, in the project that **Jim Pattison Developments** and **Reliance Properties** plan to build as part of the Burrard Gateway, only eight of the project's 87 rental units will have two bedrooms. ■

– With files from Glen Korstrom/BIV