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COVER With 40,000 moving into Metro Vancouver this year, rental apartment buildings are a prime play

Investing in residential now

FRANK O'BRIEN
WESTERN INVESTOR

Photo: Richard Lam

(L-R) Mark and David Goodman of Macdonald Commercial with a 30-suite Maple Ridge apartment building, priced at $2.8 million.

It's seen as a buyer's market for most residential property in Metro Vancouver, but the optics shift when it comes to rental apartment buildings.

Sales of private homes plunged 45.2 per cent in July compared with the same month last year, reports the **Real Estate Board of Greater Vancouver**.

Yet, in the first half of this year, and despite onerous new mortgage restrictions and taxes and extremely low capitalization rates, sales of apartment buildings increased 14 per cent from 2009, with most of the action in super-pricey Vancouver, where sales soared 28 per cent.

And suburban realtors say condo investors are starting to find that they can pencil out positive cash flows due to price cuts for existing condos combined with high rental demand.

"Vancouver prices continue to defy gravity," said **David Goodman**, apartment-building specialist with son **Mark**, and publisher of the respected *Goodman Report* for the past 27 years.

The average price per suite of city apartment buildings in the first half of this year is $218,2566, up 16 per cent over the same period in 2009, Goodman reports. Suburban apartment buildings are selling at $134,815 per door on average, up 5 per cent from a year ago.

The most expensive markets are attracting the most interest, Goodman explained, a reflection of larger investors, including real estate investment trusts, muscling into the market. In Vancouver, South Granville and the West End are the hottest areas. In the West End alone, eight buildings have sold for a total of $89.5 million – or an average of $11 million each. South Granville has seen six apartment buildings sell with suites priced at nearly $200,000 on average.

Even the slower markets – East Vancouver and Surrey, for example – are down due more to reluctant buyers than lack of demand, according to Goodman.

"Owners of larger buildings and portfolios are reluctant to sell and instead are becoming primary buyers," Mark Goodman said. In the first six months, three of the six major transactions priced at over $6.5 million were local landlords or investors, he noted.

Metro apartment buildings are seen as safe play, which has caused some real estate investment trusts to shift from other commercial assets into residential. The reasoning is solid. The rental vacancy rate remains among the lowest in Canada, at 2 per cent, and shows no sign of easing. Metro Vancouver is expected to welcome 40,000 new immigrants and migrants from other provinces this year, which will translate into 16,000 to 18,000 new households, according to the **Canada Mortgage and Housing Corp.** (CMHC).

The potential has convinced developers, for the first time in years, to start pure rental buildings, though still in low numbers. In the first half of 2010, 475 rental units were started among the near-7,000 housing starts in the Metro region.

Defying expectations

The performance of the apartment market has defied most expectations this year. Most analysts expected the harmonized sales tax (HST) to hammer the market when it came in on July 1, but so far there's no indication it has cooled demand, especially among larger investors.

The HST is tough on landlords. The

BC Apartment Owners and Managers Association notes that "property owners are in the difficult position of facing higher costs, with no revenue capacity to recover the costs directly to the operation and maintenance of rental housing units."

This is because while the HST is applied to operating and repair costs for landlords, it can't be applied to residential rents. The tax is expected to reduce landlord net operating incomes from 1.5 to 3 per cent, but rental rates are only allowed to increase 3.2 per cent this year under B.C. rent-control legislation.

David Goodman, however, notes that landlords can take advantage of the fact that rent controls are not applied when an apartment becomes vacant. Since many long-term tenants are paying below-market rents, a vacancy allows the landlord to renovate the suite and raise the rent to market values. He used the example of a "tired" South Granville apartment rented for $810 that increased to $1,150 per month after $4,200 in upgrades.

"By improving your building and your net operating income, you won't feel the effects of the HST," Goodman said.

Another barrier to local apartment investment is Canada's lowest capitalization rates, often in the 3 per cent range for the best properties. Still, **Boardwalk REIT** of Calgary is among large investors that believe southwest B.C. is the place to be: "We really don't look anywhere else," said **Bill Chidley**, Boardwalk's senior vice-president, corporate development.

Financing

The new mortgage rules that came into effect April 19 should have only a minor impact on buyers of apartment buildings, notes mortgage broker **Peter Kinch** of **Dominion Lending Centres**.

The new rules, which apply to CMHC-insured mortgage financing, mean that buyers must qualify at the five-year mortgage rate, even if they take a lower-rate mortgage, and buyers of investment homes must put down 20 per cent minimum, compared with 5 per cent.

Kinch notes that most apartment-building buyers are exempt from the CMHC regulations.

"CMHC did not make any changes to their insurance program for multifamily units, so you can still purchase an apartment building with as little as 15 per cent down as long as the cash flow warrants it," Kinch explained.

Apt. bldg. sales Metro Vancouver 2010*

Area	Sales	Avg. price per suite
East Van	3	$143,633
Kitsilano	3	$247,677
Marpole	3	$165,462
S. Granville	6	$199,029
West End	8	$238,138
Burnaby	7	$162,894
Coquitlam	1	$107,813
New West	4	$105,048
North Van	2	$131,618

*First six months
SOURCE: *Goodman Report; www.goodmanreport.com*

He advises landlords put down at least 20 per cent in any case.

The biggest adjustment for landlords is that CMHC has changed its underwriting policy. Whereas the government agency allowed for an 80 per cent offset of an investor's existing portfolio when underwriting the mortgage, it now allows a 50 per cent add back.

"This is a significant change for real estate investors," Kinch said.

> The performance of the apartment market has defied most analyst expectations this year.

The 50 per cent add back means the lender will only allow 50 per cent of the total rental income in a portfolio to be added to a borrower's income. The new income will then be multiplied by 40 per cent to determine the total verifiable income. Meanwhile, 100 per cent of the rental property's expenses is added to the borrower's debt. The only way to qualify for a mortgage, therefore, is if 40 per cent of your income can cover 100 per cent of the debt.

"If you own more than three rental properties you will never be able to qualify for a mortgage using only 50 per cent of the rental income from your portfolio," Kinch explained.

But there is fresh competition in the mortgage insurance market, with **AIG United Guaranty Mortgage Insurance Co. Canada** entering the field this year, joining **Genworth**, the other private mortgage insurer in competition with CMHC.

Genworth recently allowed 80 per cent offset for one qualified landlord, and AIG is allowing 100 per cent of rental income to be applied to an applicant's income, according to brokers close to the action.

"Amid all of the tightening for clients with rental properties, a very select few lenders are also allowing stated income for a rental-property purchase or refinance, which has traditionally been a big no-no with the banks," said **Kyle Green** of **Mortgage Alliance**.

"The lender will typically charge about 0.5 per cent higher than their best rate for income-qualified, owner-occupied properties, but this is shortening the gap for those clients that couldn't qualify for 'A' rates," he said. "Even the 'B' lenders are skeptical about lending on clients with larger portfolios, and at much higher rates than 0.5 per cent above best discounted rates. Fixed rates are coming back down closer to 4 per cent; don't wait if you need to refinance for cash or have a mortgage coming up for renewal soon."

Most lenders are also requiring that apartment investors have at least $100,000 in liquid assets and a good track record, he added. One of his clients may be forced to sell one of his five apartment buildings to refinance his existing mortgages, Green said, but he lacks the cash assets to qualify.

Generally, lenders also want to see a ratio of at least 1.1 to 1 on income versus overhead, he said.

Kinch notes that all second-tier lenders are requiring mortgages to be insured, regardless of the loan-to-value ratio.

The bottom line is that the multi-family rental market in Metro Vancouver is becoming the domain of deep-pocket investors who can handle the mortgage regulations and the low cap rates.

Condo rentals

The rental income potential, however, is also drawing smaller investors who are looking at condos for a landlord play.

Realtor **Peter Gain** of **Peter Gain and Associates** has been working in the Burnaby-Coquitlam-New Westminster market – three of the top rental markets – for 25 years and he believes the time is ripe right now for condo buyers planning to rent out their units.

"We are starting to see the investors coming back now that prices have dropped," he said.

While official real estate board statistics show that average condo prices increased from 8 per cent to 10 per cent in the Tri-Cities from a year ago, Gain said the recent reality is widespread price reductions. "A lot of people have taken their homes off the market; those that are left really want to sell."

Gain said investors can see positive cash flow if they are buying local condos – even in the $240,000 to $250,000 range – and putting 20 per cent down. However, there are plenty of condos listed for well below that price. As of press time, for instance, there were more than 30 condos listed for sale in New Westminster priced at less than $200,000, and another 55 in Coquitlam at the same price level.

"The window for investors is wide open now," he said, "but it is closing. Right now the investors hold the gold and make the rules."

Gain expects condo listings to decline and prices to firm up this fall and winter.◆

FEATURE Despite HST, low cap rates, high prices and tight supply, B.C. still seen as Canada's best market

REITs in residential

PETER MITHAM

WESTERN INVESTOR

British Columbia continues to attract multifamily property investors but real estate investment trusts are finding deals difficult to do – and don't have kind words for the hit the province's new harmonized sales tax (HST) will have on their bottom lines, either.

The strength of the B.C. rental market and access to cheap financing helped **Canadian Apartment Properties REIT** (CAP REIT) move into the province in a big way this year. It spent $37.5 million to acquire 1450 West Georgia Street in Vancouver this past spring, and in July bought eight buildings in Victoria for a total of $46.7 million. In addition, CAP REIT opened a management office in Vancouver to oversee its B.C. operations.

"We like those markets, we think there's good upside potential," said **Thomas Schwartz**, president and CEO of CAP REIT, citing the stability of the region's real estate, constraints on new development and a growing population as factors in its optimism.

"There's no new supply. So you have growing demand in a market with finite supply," he said.

The diversity of the market, with its mix of newcomers, young professionals and seniors also make it attractive, Schwartz said, because landlords aren't reliant on just one type of tenant for occupancies. This further reduces the risk of the investment.

But CAP REIT's success in building its B.C. portfolio this year hasn't been shared by other players.

While all major multifamily REITs have properties in B.C., adding to holdings is difficult because few owners are willing to sell what many consider to be extremely stable investments.


Photo: Peter Mitham

Canadian Apartment Properties REIT bought the rental tower at 1450 West Georgia for $37.5 million: "we think there's good upside potential."

Tight supply

"Owning apartments seems like a relatively safe haven," said **James Britton**, CEO of Calgary's **Northern Property REIT**. "So the people that own them are kind of holding on to them and those of us who want to buy them are finding it difficult to find a sweet spot as we negotiate. People that got 'em think they're worth more than we do, so there's not a huge amount of transactions going on."

Bill Chidley, senior vice-president, corporate development, with **Boardwalk REIT**, another Calgary-based investor, said his company's tight focus on Metro Vancouver and Victoria is matched by the tenaciousness of owners who aren't willing to let properties go.

The company has a total of 954 units, with 657 in the Lower Mainland and just 257 units in Victoria. "We really don't look anywhere else," Chidley said. And while Boardwalk wants to expand, the properties it encounters often don't pencil out.

"We'd like to increase our position. What we're finding, though, is a very, very competitive market to acquire apartments. They sell at quite low cap rates, so it's challenging," Chidley explained.

David Goodman at **Macdonald Commercial Real Estate Services Ltd.** said strong demand – Metro Vancouver apartment sales totalled 40 in the first half of 2010, the highest in two years – has driven capitalization rates down to "preposterously and historically lows," at between 3 per cent and 5.75 per cent.

B.C. rental vacancy rates and rents

City	Vacancy rate	2-bdrm. avg.
Vancouver	2.2%	$1,150
Victoria	2.5%	$999
Nanaimo	4.3%	$773
Prince George	6.6%	$697
Kamloops	2.3%	$830
Kelowna	3.7%	$896
B.C. avg.	**3.1%**	**$983**

Source: CMHC *Rental Market Report*, Spring 2010

Low cap rates

While the large run of investors are undeterred by such low cap rates given the strength indicated of local markets, Chidley said it makes it difficult for Boardwalk to justify.

If his company could be assigned a cap rate, based on the market valuation, he says it would be trading at something above 6 per cent. To buy into a market with a sub-5 per cent cap rate would dilute its value.

"It's been quite difficult for the past couple of years, because of the pricing," Chidley said. "It doesn't mean that we can't pay a little less than a 6 per cent cap if we find a property that's an extraordinary opportunity, but it does make it challenging without, in effect, diluting our existing units."

Canada Mortgage and Housing Corp. (CMHC) has helped maintain deal flows, but Chidley notes that it's also injected enough liquidity into the market to buoy property prices in a market with strong fundamentals already supporting high valuations.

"Capital is plentiful because of CMHC financing," he said. "You have a lot of capital available and good fundamentals, so pricing is quite aggressive."

Still, Schwartz believes CMHC financing is the saving grace of the B.C. market. Part of a panel discussing growth prospects and strategies for REITs at the Real REIT conference in Toronto on September 14, Schwartz said

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growth of the multifamily investment market generally owes much to plentiful CMHC financing.

"CMHC financing rates are extremely attractive today. So that's not just driving us, it's driving the whole apartment market."

While deals such as CAP REIT's bid for 1450 West Georgia may be unsolicited, a good financing environment has allowed companies to take a stake in urban markets.

Secondary markets

But the investment environment isn't much different outside the main centres.

Northern Property REIT considers multifamily properties an important entry point in the markets that it invests in, most of which are oriented toward the resource sector. It owns three properties in Nanaimo, but the majority of its holdings are in the oil and gas fields of the Peace River district, and north of Dawson Creek along the Alaska Highway.

"[These communities] have lots of activity going on in the resource sector, and lots of government support, so we like being in business there," said Britton, noting that each market will have its advantages and disadvantages but in general tend to balance one another.

"We find it's important for us to have some diversity in our portfolio. If one place is struggling, another place, sometimes another community, will be doing OK and offset that."

Still, they require prudence.

He has previously remarked that outlying markets are vulnerable to over-investment, especially by developers. This can compromise the value of properties to REITs and other investors, especially when booms go bust.

"You have to understand the local economy pretty intimately before you decide to build in these places, because the markets are not deep. They're good but they're not deep," he said.

But, again, diversification helps, which is why a smaller urban market like Nanaimo is a good fit with its portfolio. With consistently low vacancies, Nanaimo can offset a double-digit spike in vacancies in a market such as Chetwynd.

HST pain

The one variable all REITs are having difficulty swallowing is B.C.'s harmonized sales tax. "I don't think that the government of British Columbia set out to cause pain for us, but they did," Britton said bluntly. "There's winners and losers in these things, and we happen to be losers."

While most of his REIT's assets are in markets other than B.C., and the impact of the HST on his own bottom line is limited (Britton describes it as "a sting rather than a body blow"), the new tax does not make the province a more competitive place for apartment investors who – unlike commercial landlords – can't recoup the tax from tenants.

"If our entire apartment portfolio were in British Columbia, it would be something to think about," Britton said.◆