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**The Financing & Economics
of Affordable Housing
Development:
Incentives and Disincentives to
Private-Sector Participation**
Jill Black

Research Paper 224

Cities Centre, University of Toronto
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Executive Summary

The development of multi-unit residential housing is a complex, costly, capital-intensive, and risky business, particularly for the major players: real estate developers, owners of rental buildings, and financiers of development projects and long-term mortgages. All expect their financial returns to be commensurate with the risks they assume, and all need to cover their investment of time, money, and expertise.

The purpose of this paper is to help a broader audience unfamiliar with real estate finance to understand the economics of the major for-profit players, or “how they make money.” Better understanding of the for-profit real estate business and the issues faced by for-profit players in rental development should help generate ideas for incentives (or ways to overcome disincentives) to stimulate greater private-sector involvement in creating affordable multi-unit rental housing.

The paper uses simplified financial models to explain and compare the economics of for-profit condo development, for-profit apartment development, and affordable rental development. The models show that a for-profit developer would need to charge luxury rents of more than double an affordable rent level to reach a minimum acceptable profit margin. Charging lower rents means insufficient income to cover interest costs – that is, bankruptcy. This is why it is not economically attractive for the private sector to participate in the creation of multi-unit rental housing, particularly in large urban centres like Toronto.

Toronto’s high land prices and construction costs, difficulty obtaining financing on favourable terms, and lack of incentives to create rental apartments make rental development riskier and less profitable than condominium development. This is true even for luxury apartments demanding high rents, and even more so for affordable rental development, which is not economically feasible without significant government subsidies.

Even when subsidies are available, private-sector involvement in creating affordable rental is hampered by uncertainty about government commitments to programs that support the creation of affordable rental housing (such programs have sometimes been cancelled with little notice); government requirements that result in higher construction and operating costs for affordable rental buildings; and other irritants that make it difficult and time-consuming to obtain building permits, zoning approval, and construction and mortgage loan insurance.

What would it take to increase private-sector participation in creating or helping to preserve affordable rental housing? The people interviewed for this paper had many ideas that would improve the economics by reducing costs and risks and streamlining approval processes. Reducing land costs, potentially by freeing up surplus government land, was considered most important in combination with government grants or tax incentives. There were also ideas for reducing construction costs by lowering soft costs (such as those for environmental assessments or development charges) and by changing building codes to allow less expensive wood frame construction for low-rise rental buildings. Every development is different and many would like to see a “menu” of incentives that could be applied as appropriate for the situation.

Improved access to financing at favourable terms was also considered essential. Loan guarantees by government would help remove lenders' risk in the event of default. Ideas for bringing in new investors included reinstating an updated and more targeted version of the Multi-Unit Rental Building (MURB) tax incentive programs of the 1970s and 1980s and developing new financial vehicles, potentially similar to those in the U.S. or U.K., to attract private investment.

Measures to ensure that owners of aging affordable rental stock maintain their buildings appropriately are also needed. Interviewees felt that rehabilitating aging, poorly maintained apartment buildings would not only benefit the tenants, but would also attract a broader mix of incomes to rental housing, reducing the concentration and isolation of low-income tenants. They favoured a combination of "carrots and sticks" for owners who fail to maintain their rental buildings. "Carrots" included tax incentives to free up funds for rehabilitation and "sticks" included stronger enforcement and larger financial penalties for non-compliance.

Finally, the paper includes proposals to encourage the sale of rental buildings to non-profit groups to ensure that the units remain affordable – the suggestions included tax incentives, such as deferring tax on capital gains, and new financing vehicles that would enable non-profits to compete with for-profit Real Estate Investment Trusts for properties in good condition.

Author

Jill Black is a strategy and policy consultant. She is a former partner of the Boston Consulting Group, a global management consulting firm, where she spent more than 15 years providing strategic advice to major business corporations. She left Boston Consulting to become an independent consultant and to apply her skills to issues in the non-profit and public policy arenas. Her assignments have included helping to set up and create the agenda for the Toronto City Summit Alliance (TCSA) as its first executive director, and serving as project director and co-chair of the Working Group for the TCSA's Task Force on Modernizing Income Security for Working-Age Adults.

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1. Introduction

“A stable, affordable place to live is the basic ingredient, the primary building block from which all Canadians have a chance to realize their potential and make a positive contribution to their community and country.”¹

This paper was written for the Neighbourhood Change Community University Research Alliance (CURA), a joint research initiative between the Cities Centre (formerly the Centre for Urban and Community Studies) at the University of Toronto and St. Christopher House. The Neighbourhood Change CURA studied West-Central Toronto’s older inner-city neighbourhoods, which are experiencing increasing pressure from redevelopment and gentrification, both of which make good-quality housing increasingly unaffordable and can lead to the displacement of lower-income residents. Preserving affordable, well-maintained housing is essential to help combat these pressures.

The Neighbourhood Change CURA has carried out research focused on the many social and economic benefits of providing good-quality, affordable housing in mixed-income neighbourhoods. It has developed a set of policy recommendations to help preserve mixed-income neighbourhoods downtown by encouraging the development of new affordable housing, keeping existing rental buildings affordable, and reducing the potential for displacement of existing residents.²

This paper is intended to complement the Neighbourhood Change CURA’s efforts by providing a different perspective on affordable housing – that of the private sector.³ The private sector has not been very active in multi-unit rental development for some time because the economic potential is poor.⁴ Even at “luxury” rents, rental development is far less profitable than condo

1 Mitchell Cohen (2005), “A Home for All Canadians,” *Condo Life*.

2 See <http://www.urbancenter.utoronto.ca/cura/index.html> for the Neighbourhood Change CURA’s research and recommendations.

3 The term “private sector” in this context refers to the real estate industry, which is composed of many distinct businesses, including development, construction, construction management, financing and brokerage, and property management – as well as the specialists and advisors who support real estate businesses.

4 In discussing the “economics” of for-profit participants in real estate development, the term “economics” is used in the business sense – that is, how these businesses make (or lose) money.

development while “affordable” rental development is not economically feasible without significant government subsidies. Key contributing factors include:

- Limited revenue potential, as renters earn approximately half as much as owners, while the costs for land and construction are similar for rental and condo development – and have been driven up in major markets by the boom in condo development over the past decade
- The fact that governments first reduced and then eliminated subsidies and other incentives to the development of purpose-built, affordable multi-unit rental.

Table 1 shows the effects of these factors in the amalgamated City of Toronto (formerly Metro Toronto), as rental stock grew through the 1960s, 1970s, and 1980s, and then shrank over the 1996-2006 period, while homeownership experienced strong growth.

Table 1: Housing stock and change in housing stock in the City of Toronto (formerly Metro Toronto), 1966-2006, for owned and rental housing, showing trends in the proportion of stock in social housing

Total Housing Stock	1966	1971	1976	1981	1986	1991	1996	2001	2006
Metro/Amalgamated Toronto									
Owned	307,500	320,800	364,400	395,500	414,000	415,700	428,200	478,500	532,600
Rental	209,200	308,500	348,600	380,800	402,900	448,800	470,300	464,500	446,700
Total	516,700	629,300	713,000	776,400	816,500	864,500	898,500	943,100	979,300
Social housing	10,300	24,600	40,500	53,700	68,400	76,400	89,700	91,400	93,100
Social housing % of Rental	4.9%	8.0%	11.6%	14.1%	17.0%	17.0%	19.1%	19.7%	20.8%
Social housing % of All	2.0%	3.9%	5.7%	6.9%	8.4%	8.8%	10.0%	9.7%	9.5%

Net Change in Housing Stock	1966-71	1971-76	1976-81	1981-86	1986-91	1991-96	1996-2001	2001-06
Metro/Amalgamated Toronto								
Owned	13,300	43,600	31,200	18,500	1,700	12,500	50,300	54,000
Rental	99,300	40,100	32,200	22,100	46,000	21,500	-5,800	-17,800
Total	112,600	83,700	63,400	40,100	48,100	34,000	44,500	36,300
Social housing	14,300	15,900	13,200	14,700	8,000	13,300	1,700	1,700
Social housing % of Rental	14.4%	39.7%	41.0%	66.5%	17.4%	61.9%	--	--
Social housing % of All	12.7%	19.0%	20.8%	36.7%	16.6%	39.1%	3.8%	4.7%

Sources: CMHC completions data, census, social housing administrative data. Compiled by Greg Suttor, AHO, City of Toronto; except 2006 social housing data, estimated by author.

In addition to the work of the Neighbourhood Change CURA, numerous research papers have explored the factors contributing to the lack of affordable rental housing, and the lack of private-sector involvement in rental development.⁵ The audiences for this work are typically economists or policy analysts who understand the complex issues involved. The purpose of this paper is to help a broader audience understand the issues by using simplified financial models to explain the economics of for-profit real estate development and financing and to demonstrate the magnitude of the gap between financial returns that for-profit players are prepared to accept and the potential financial returns from multi-unit rental development.⁶ The purpose of explaining the economics of for-profit real estate development and financing is to:

- identify incentives and disincentives for private-sector involvement in financing and developing new affordable rental housing;
- identify incentives and disincentives to ensure that for-profit owners keep their rental buildings affordable and maintain them well
- stimulate discussion and debate of potential policy recommendations to encourage more private-sector participation in the creation of affordable rental housing.

The issues and ideas in this paper have been informed by more than 25 interviews with participants in real estate and affordable housing development from the private, non-profit, academic and government sectors,⁷ a review of the literature on the topic, and the author's extensive business experience.

The report begins with an overview of the key players in the real estate development industry and explains how they make money. It then focuses on affordable multi-unit rental housing, because that is the area of greatest need and the area with the most problematic economics for for-profit development.

5 The Reading List at the end of this paper contains several comprehensive reports, including the work of consultants such as Ernst & Young and Steve Pomeroy, academic experts such as Marion Steele, private-sector economists such as those at TD Economics, and experts from various associations.

6 The examples used in the paper were derived from a model for an affordable rental development that was in the process of securing financing. The term "affordable" has many interpretations and definitions. The affordable rental model in this paper is based on rents at 80% of the market average, which would make it eligible for the Canada-Ontario Affordable Housing Program.

7 Interviewees and expert contacts are listed in Appendix I, labelled by sector and profession rather than by name, for reasons of confidentiality, using reference codes that are also explained in the Appendix. Several interviewees are actively involved in development of affordable ownership housing, which could be the subject of similar analysis and discussion in the future.

2. Research Approach

The research approach for this paper involved financial modelling, interviewing, and a literature search. Because this is a technical paper intended to explain the economics of for-profit real estate development and how it differs from the economics of affordable rental development, the emphasis is very much on financial modelling. The interviews and literature search focused on gathering information to help build and test the models. The work involved the following tasks.

- The author modelled the economics of for-profit and affordable multi-unit rental housing, using a model of a 190-unit affordable rental housing development being built in Toronto. The affordable development project is being done using a “turnkey” approach, in which a for-profit developer takes a project to the end of construction and then turns it over to a non-profit organization that owns and operates the building.⁸ The data for the affordable base model was provided by an underwriter from Infrastructure Ontario, with the permission of the developer.

The affordable base model was modified to create financial models that reflect the economics of for-profit development for ownership (condo) and for (luxury) rental, by adjusting the financial structure and adding in costs that affordable rental developments typically do not incur (e.g., municipal development charges). The for-profit ownership and rental models were then designed to generate the financial returns or profitability levels that interviewees considered “acceptable” by adjusting the selling price or rent level to achieve the required returns.

- The author also interviewed more than 25 participants involved in for-profit and affordable rental housing from the private, non-profit, academic, and government sectors as well as consulting with a number of experts in telephone calls and e-mail exchanges. Names of interviewees have been disguised to maintain confidentiality. The reference codes used for disguising the names are explained in the Interviewees and Expert Contacts List in Appendix I. Opinions expressed by interviewees are included in the paper where relevant; they are not necessarily shared by the author.

8 The turnkey development approach is one of several approaches possible under the Canada-Ontario Affordable Housing Program. It is used here because the financial models developed for the paper are based on a model of a real affordable turnkey rental development. This approach was also favoured by many of the interviewees.

- The author searched the extensive literature on affordable housing, focusing on research conducted by governments, academics, associations, and advocacy groups. The Reading List contains some of the more useful reports and articles.

The paper also includes interviewees' suggestions for stimulating private-sector participation in financing and developing affordable housing, as well as their thoughts on proposed policies and programs from the work of the Neighbourhood Change CURA.⁹ The former are in the final section of the paper and the latter are in Appendix II.

It is beyond the scope of this technical paper to assess the effectiveness of the ideas, but they have been included for the sake of completeness and to help stimulate discussion, as well as to indicate opportunities for further research and development.

9 The Neighbourhood Change CURA's "Policy options for maintaining good-quality, socially mixed, inclusive neighbourhoods" can be found at http://www.urbancentre.utoronto.ca/redirects/tnrn_policyoptionsdiscussion.html

3. How key players in real estate development make money

“It’s been years since I last saw a pro forma for a rental development that generated higher revenue than costs. Toronto land and construction are expensive. Even high priced rental can’t support the cost.” (PSF)¹⁰

Real estate development is a complex, costly, capital intensive, and risky business, particularly for the key players: the real estate developers who orchestrate the process and participants, the owners and operators of multi-residential properties, and the financiers (brokers, lenders, and investors) who fund development, construction, and mortgages.

Table 2 on the following page sets out the key activities and risks at each of the three main stages of the development process: predevelopment planning, development and construction, and occupancy and management. These risks are real and can be expensive, particularly if they result in unexpected delays, as construction costs alone have increased by roughly 10% a year since the late 1990s.

The following sections discuss the economics of each of the key players: developers, owners and financiers, including what they need to be good at to be successful, what financial returns they expect, how they measure them, and how they manage risk.

¹⁰ This code refers to an interviewee, in this case a private-sector financier. The full list of reference codes appears in Appendix I.

Table 2: Real estate development risks by phase

Phase of Development	Primary Activities	Timeframe	Risks for Multi-Unit Rental Development ¹
Pre-development and Entitlement Approval	<ul style="list-style-type: none"> • Locate /control site² • Planning • Pre-development loan • Env'l assessment • Preliminary design • Financial feasibility • Municipal planning approval • Construction financing 	0.5 to 5+ years • Depends on size and complexity	<ul style="list-style-type: none"> • Anything that adds time, e.g.: environmental issues; 'NIMBYism'; need for variances, re-zoning, or official plan amendments • Interest rate increases • Public policy changes • Inability to secure financing • Construction cost increases
Development and Construction	<ul style="list-style-type: none"> • Acquire site • Detailed drawings • Building permits • Select contractor • Construction • Marketing • Mortgage financing 	0.5 to 5 years • Or 0.5 to 2 years after pre-sales if ownership property (e.g. condo) • Depends on size and complexity	<ul style="list-style-type: none"> • Market or economy changes • Public policy changes • Cost over-runs, e.g. due to strikes, bad weather, etc. • Interest rate increases before mortgage financing is locked in • Can't secure long-term financing • Financers risk loan default
Occupancy and Management	<ul style="list-style-type: none"> • Marketing • Property management • Paying expenses • Maintenance and repair • Paying off debt 	Maximum would be the life of the building	<ul style="list-style-type: none"> • Marketing risk • Tenant credit risk • High vacancy • Excessive damage • Interest rate increases

1. Developers' risks unless otherwise specified

2. A site could be purchased on spec and held for a longer period, e.g. if in a potential growth area. Costs would include holding the land, salaries and taxes. Risks include public policy changes or market assessment not being as favourable as expected

Developers' Economics

Developers orchestrate the development process from beginning to end. Their activities include buying land; securing financing for real estate deals; designing and planning projects; securing public approvals; retaining builders; overseeing construction; marketing properties; and leasing, renting, or selling property developments. They work with many different specialists or service providers throughout the development process, including brokers and lenders, underwriters, insurers, lawyers, surveyors, designers, architects, engineers, building contractors, and city planners. They take the greatest risks of all of the participants, for which they expect to realize the greatest rewards.

To be successful, developers must be very good at selecting and acquiring superior sites, project management, cost control, and negotiating favourable financial deals. Fostering good relationships with financiers and developing and maintaining a network of known and reliable service providers are critical. They also need liquidity (or a cash cushion) in case projects turn out differently from their original projections.

Residential real estate developers make money in one of two ways:

- **Develop and sell:** this means developing, building, and selling a building, or units in a building, and realizing a profit after covering the costs of pre-development, development and construction.

- **Develop and rent:** this means building and retaining ownership, earning a return on their investment from rental income generated over a number of years and ideally from capital gains realized upon sale.

This section will focus on the economics of developing and selling. The economics of developing and renting are discussed in the section on owner economics.

Developing for sale is the primary way that developers make money. Even if they build to rent, and few do so, developers reportedly try to get their own money or equity out as soon as possible after construction is complete. The pro forma financial statement in Table 3 illustrates the economics of developing and selling a 190-unit condo development.

Table 3: Pro forma for a 190-unit condo development

Pro forma	Total \$000s	\$ Per Unit
Sales Revenue	\$ 54,150	\$ 285,000
Costs		
Land Cost	\$ 8,000	\$ 42,105
Hard (Construction) Costs	\$ 28,930	\$ 152,262
Soft (Development) Costs	\$ 9,043	\$ 47,595
Total Project Cost	\$ 45,973	\$ 241,962
Profit and Financial Return		
Developer's Profit, Pre-Tax	\$ 8,177	\$ 43,038
Profit Margin (Profit/Revenue)	15%	15%

Source: Affordable housing financial model provided by PD2 and author's analysis

In this example, the developer has completed a two-year project costing almost \$46 million, sold the units for \$285,000 each on average, and made a profit of \$8.2 million after covering “hard costs” (the costs of construction) and “soft costs” (development and related charges, interest, administration, specialists/services, marketing and other costs).¹¹ The developer’s financial return, or profit margin before interest and taxes, is 15% of revenue, the target margin that interviewees said for-profit developers aim for.¹² If a pro forma for this type of development failed to generate a profit margin in the 10% to 15% range, the project would likely not proceed

The “develop and sell” approach is not risk-free. The primary risk for condo developers is the failure of a project, which could result in the loss of 100% of their equity and expose them to lawsuits by lenders seeking to recover their losses. “Develop and sell” is nonetheless more attractive than rental development for the following reasons:

- Risks are lower than rental development because much of the financing for construction is withheld and construction cannot begin until the majority of units are pre-sold to qualified buyers.

11 See the Glossary at the end of the report for detailed definitions.

12 Profit margin is calculated before interest and taxes to level the playing field because different developers have different financing capabilities and would therefore pay different interest rates on loans for similar projects.

- Costs are lower because pre-sales bring in cash earlier reducing the amount of debt financing and associated interest charges.¹³
- It is easier to obtain financing because of the lower risks and costs, which means that projects tie up less of a developer's equity for shorter periods.

Once a project is built, a developer with a property management division might operate the building for a fee, but the condo association becomes responsible for the building and bears the occupancy and management risks – and headaches.

Owners' Economics

Owners of multi-unit rental properties include companies that “develop to rent” as well as companies such as Real Estate Investment Trusts (REITs), which buy and manage existing rental buildings. This section focuses primarily on the former and concludes with a brief discussion of differences in the economics of new rental development projects versus buying and managing existing rental buildings.

Owners' Economics for New Development

Few companies develop for rent, because it is extremely difficult to make an adequate return, particularly in large cities where land costs are high.¹⁴ The rents required to make a profit are very expensive, limiting the potential market for the units. The financial model in this section illustrates this problem.

To assess the feasibility of a rental project, a developer would first create a single-year pro forma to determine if the project has the potential to generate an acceptable return on the equity investment. Again using the example of a 190-unit building, Table 4 shows the annual pro forma for a new rental development that has achieved operating stability¹⁵ and has similar construction costs to the condo example.¹⁶ The pro forma is more complex than the financial model for “development for sale,” because it goes beyond construction costs to include revenue generating potential as well as the costs of operation and ongoing mortgage financing (debt servicing).¹⁷

13 Prospective buyers typically make cash deposits of 10% or more of the sales price to hold their units.

14 An exception would be Concert Properties, which both develops and acquires rental buildings. Concert undertakes rental development when it can get land cheaply enough to make the economics work. It reportedly has lower-than-typical required return targets because it is owned by Canadian union and management pension funds which invest for the long term.

15 Stabilized operation means that rent and operating income have reached projected levels which can take time, as buildings do not always fill up quickly.

16 Rental construction costs are higher than those for a condo development because there are no pre-sales.

17 After construction, the short-term construction loan is typically converted to a long-term mortgage.

Table 4: Preliminary pro forma for a 190-unit for-profit rental development (\$000s)

Operating Pro forma	
Gross Revenue (based on average rent of \$2,250/month)	\$ 5,132
Vacancy and Bad Debt Allowances	-\$ 205
Net Revenue	\$ 4,927
Operating Costs	-\$ 1,649
Net Operating Income (NOI)	\$ 3,279
Financing	
Debt (80%)	\$ 38,159
Developer's Equity (20%)	\$ 9,210
Total Financing	\$ 47,369
Debt Service Costs (35 Years; 5% Interest)	
Interest	-\$ 1,908
Principal	-\$ 422
Total Debt Service	-\$ 2,330
Profitability	
Cash Flow Pre-Tax (NOI - Debt Service)	\$ 948
Cash-on-Cash Return (Cash Flow/Equity)	10%
Note: The sample project contains a mix of suite sizes. The average rent calculation was weighted by suite size.	
Source: Affordable housing financial model provided by PD2 and author's analysis	

Cash-on-cash return is the measure commonly used to test a project's economic feasibility because it provides a quick and easy way to compare the profitability of income-producing properties.¹⁸ Required cash-on-cash returns for a viable project are reportedly in the range of 10% to 15%.¹⁹ The returns from the example fall within the required range because the financial models were designed to produce acceptable returns by ensuring they generate sufficient income; which required a minimum average rent of \$2,250 per unit in this example.

Before a project goes ahead, a long-term projection would be developed to confirm economic feasibility and to help secure financing. Table 5 shows the first and last years of the long-term financial projection for the 190-unit rental development, assuming it is sold at market value after 20 years. It illustrates how an owner might manage the building to maximize profitability and increase market value over time. Here are the highlights (shaded in Table 5):

- Net operating income (NOI) grows from \$3.3 million to \$4.8 million. NOI growth is critical, as it drives both profitability and market value. An owner would attempt to grow revenue, ideally at a higher rate than operating costs, to maximize operating income

18 Cash-on-cash return is calculated by dividing pre-tax cash flow (net operating income after debt service and pre-tax) by the developer's equity.

19 Long-term "patient" investors, such as pension funds, might accept a lower return, but developers reportedly aim for the higher end of the range. Developers and investors may also accept lower returns when markets are strong and they have high expectations of capital appreciation.

growth. This can be difficult in highly competitive and rent-controlled environments.²⁰ In the latter, some owners may attempt to justify higher increases than rent controls allow by making modest capital improvements; less scrupulous owners might scrimp on maintenance to reduce operating costs and inflate operating income.

- Market value grows from \$49 million to \$71 million based on a capitalization rate (cap rate) of 6.7%. The cap rate is the percentage used to determine the market value of a property based on its estimated future net operating income; the current property value is equal to NOI divided by the cap rate. Cap rates are based on appraisals of recent sales of similar properties. Real estate service companies, such as Colliers International, regularly publish cap rates for major markets. The cap rate for Toronto was in the 6% to 7% range when this paper was written.
- The market value of the owner's equity in the property grows from \$11 million to \$46 million as the market value increases and the mortgage loan is paid off. The former is implicitly captured in the cap rate, because expectations of high capital gains lead to lower cap rates and therefore higher market values.
- Tax laws allow the owners of rental buildings to claim capital cost allowance (CCA) for a new building of 2% in the first year and 4% in subsequent years, and subtract it from pre-tax income before calculating their taxes.²¹ CCA is calculated on a declining balance which means that the base for the calculation is net of the CCA from the prior year (see Glossary for explanation). As a result the un-depreciated capital cost (UCC) of the building declines from \$37 million to \$17 million over 20 years. This decline has implications when a building is sold, a situation addressed in the next section.²²
- Owners measure profitability by calculating return on equity (ROE) at points in time and internal rate of return (IRR) over time.²³ In this example, ROE falls from 9% in Year 1 to 8% in Year 20, as book value increases. In the real world, an owner would improve ROE by refinancing (borrowing against growth in value), or by selling the building to pursue higher returns elsewhere. The latter action would generate an IRR of 17%.²⁴

20 Rent control in Ontario applies only to existing tenancies, not to new buildings or to apartments that have been vacated. The competitive environment is the primary influence on rents when rent controls are not applied.

21 Because the capital cost allowance is calculated before tax, it reduces taxable income, and therefore reduces the income taxes payable, which improves returns. This is why increasing the CCA rate is often recommended as a means of stimulating more rental production.

22 Some past affordable housing programs provided an incentive for for-profit developers to build affordable housing by allowing higher CCA deductions and the application of resulting tax losses against other income (not just other rental income). There is some dispute as to what the true CCA should be. TD Economics concluded in a 1993 paper that 4% is higher than the real rate of obsolescence, a finding consistent with the work of tax experts such as Fallis and Smith (cited by Steele and Des Rosiers, 2009) who believe that the depreciation rate is between 1% and 2%. In contrast, a 2009 paper by the Canadian Federation of Apartment Associations quoted the 2005 work of Fisher, Smith, Stern, and Webb ("Analysis of Economic Depreciation for Multi-Family Property," *Journal of Real Estate Research*, vol. 27, no. 4), which demonstrated that the actual depreciation rate is 3.25% plus inflation, which equated to a nominal rate of 5.05% when this paper was written.

23 ROE is calculated by dividing cash income by equity invested.

24 IRR is a robust measure of percentage return from the initial equity investment that takes into account the initial investment, timing and scale of future cash flows, and the future value of the property (see Glossary for more detail).

Table 5: 20-year financial projection for a 190-unit for-profit rental development (\$000s)

Key Variables	Year 1	Year 20
Operating Income & Expenses		
Gross Revenue	\$ 5,132	\$ 7,477
Vacancy and Bad Debt Allowance	-\$ 205	-\$ 299
Net Revenue	\$ 4,927	\$ 7,178
Operating Costs	-\$ 1,649	-\$ 2,402
Net Operating Income (NOI)	\$ 3,279	\$ 4,776
Market Value (NOI/7% Cap Rate)	\$ 48,934	\$ 71,288
Mortgage Balance	\$ 38,159	\$ 25,256
Equity	\$ 10,776	\$ 46,032
Debt Service Costs (35 Years; 5% Interest)		
Interest	-\$ 1,908	-\$ 1,263
Principal	-\$ 422	-\$ 1,068
Total Debt Service	-\$ 2,330	-\$ 2,330
Cash Flow Pre-Tax (NOI - Debt Service)	\$ 948	\$ 2,446
Non-Cash Expense		
Capital Cost (Building Cost ex Land)	\$ 38,051	
Capital Cost Allowance (2% Year 1; 4% ongoing)	-\$ 761	-\$ 715
Un-depreciated Capital Cost (UCC)	\$ 37,290	\$ 17,169
Income Taxes		
Taxable Income (NOI - Debt Service - CCA)	\$ 187	\$ 1,731
Income Tax (33%)	-\$ 62	-\$ 571
After Tax Income	\$ 125	\$ 1,159
Profitability		
Cash Income (Income After Tax and Pre-CCA)	\$ 886	\$ 1,875
Annual Return on Equity At Book Value (Cash Income/Book Value)	9%	8%
Internal Rate of Return on Sale at Market Value after 20 Years		17%

Source: Affordable housing financial model provided by PD2 and author's analysis

While the rental example generates an “acceptable return,” it is likely unrealistic, because the average rent per unit has to be set very high (\$2,250 per unit on average) to generate that return – more than double what might be considered affordable to a low-to-moderate income earner.²⁵ Even at these high rents, developing multi-unit rental is riskier than developing for sale because it is difficult to assess and demonstrate financial feasibility. This makes multi-unit rental less attractive to financiers, who pass the higher risk back onto developers in various ways. These include requiring developers to purchase mortgage insurance from Canada Mortgage and Housing Corporation (CMHC) to protect lenders against loan default and delaying

²⁵ This is true for the example. In reality, there is no “typical” acceptable return for developing rental buildings, as developers try to get most of their money out of projects after construction is complete and they may be willing to take a lower long-run return if they succeed in doing so. They may also be willing to accept lower annual income and returns in very strong markets in which they have high expectations for strong growth in market value. As a result, interviewees have seen long-run IRRs ranging from 0% to 30%.

mortgage financing until rents have stabilized,²⁶ actions that increase costs, making the economics worse.

In addition to trying to get their own equity out at the end of the construction phase, developers mitigate risks and minimize financial burdens in a number of ways, such as doing their homework to ensure that they have a good understanding of the rent levels their markets will support, making investments in the construction phase that reduce on-going operating costs, building in contingencies such as vacancy allowances, and refinancing on more favourable terms when rents and operating costs are known and stable.

The Economics of Disposition of Rental Buildings

Before looking at the economics of owning acquired buildings, it is helpful to understand the economics of disposition (sale), as these can influence developers' decisions about new developments, as well as owners' willingness to sell older buildings. Table 6 shows the calculation of proceeds from the sale of the 190-unit building, assuming it was held for 20 years.

The owner realized \$30 million on the sale of the building, well below the market value of \$71 million, because certain costs need to be deducted from the gross proceeds – some of which can be substantial for buildings owned for a long period of time. The deductions in the example include:

- paying off the mortgage, which had an outstanding balance of \$25 million;
- selling costs, which amounted to \$3.5 million;
- capital gains tax, which reduced the sales proceeds by \$5.5 million;²⁷
- taxes on Capital Cost Allowance (CCA) recapture, which reduced the sales proceeds by almost \$7 million.²⁸

If the owner had refinanced the building during the 20-year period, and pulled the equity out, the owner would have had a larger outstanding mortgage and higher taxes, and therefore lower and potentially negative proceeds – which would be a disincentive to selling a building if it is in good condition and generating strong cash flow.

26 For CMHC, stabilized operation means that operating income has been sustained at the projected rent levels through at least one full operating year.

27 The owner's capital gain is calculated by subtracting the original equity investment from the gross sales proceeds; 50% of the capital gain is treated as income and taxed accordingly, at the business tax rate of 33% in this case. (Note that the tax rate could be much higher for individual owners/investors or partnerships; potentially as high as 46% in Ontario).

28 The CCA recapture is equal to the amount of CCA expensed over the 20 years (the original cost of the building minus the un-depreciated capital cost); 100% of it is taxed as income.

Table 6: Proceeds from the sale of a 190-unit for-profit rental development held for 20 years (\$000s)

Key Variables		
Market Value in Year 20	\$	71,288
Mortgage Outstanding	-\$	25,256
Sales Costs (5%)	-\$	3,564
Gross Proceeds from Sale	\$	42,467
Original Equity	\$	9,210
Capital Gain	\$	33,257
Taxable Capital Gain (50%)	\$	16,629
Capital Gains Tax (33%)	-\$	5,487
Original Cost of Building (ex. Land)	\$	38,051
Un-depreciated Capital Cost in Year 20	\$	17,169
CCA Recapture	\$	20,882
Tax on CCA Recapture (33%)	-\$	6,891
Total Proceeds from Sale After Tax	\$	30,089
Source: Affordable housing financial model provided by PD2 and author's analysis		

Owners' Economics for Acquired Buildings

Existing rental buildings are bought and sold all the time. In a 2009 paper commissioned by the Ontario Non-Profit Housing Association (ONPHA), Steve Pomeroy of Focus Consulting indicated that the majority of sales are of larger buildings favoured by REITs and large institutional investors (such as pension funds and insurance companies) that invest for the long term. He also reported significant sales volumes of small-to-mid-sized buildings totalling more than 3,000 units each year in 2005 and 2006 – “substantially larger volumes of sales than the total number of new rental units constructed annually, and far more than the number of affordable new units constructed annually.”²⁹

The economics for owners of acquired buildings are similar to those for a new development for rental, with one major difference: acquired buildings cost roughly half as much as new construction. According to Pomeroy, in 2005-2006 existing buildings were selling for \$80,000 to \$90,000 per unit versus \$200,000 or more per unit for new build.³⁰ Lower capital and financing costs enable owners to make acceptable returns, even though older buildings tend to have lower rents and higher operating costs than new developments, and their owners pay higher

29 Steve Pomeroy (2009), “Understanding the Affordable Housing Issue: Background Diagnostic in Support of ONPHA’s Response to Long-Term Affordable Housing Strategy.” Appended to “Rebuilding the Foundations: ONPHA’s Vision for a More Effective Affordable Housing System in Ontario.”

30 Construction cost inflation since 2005-2006 would have increased the cost for new build to over \$250,000 per unit, making higher subsidies necessary to achieve affordable rent levels.

property taxes.³¹ Purchasers such as REITs, private equity funds, and individual investors look for undervalued assets that are in reasonably good shape. They increase their cash flows over time as rents increase with inflation, while debt service remains constant over mortgage terms (as interest rates permit). They may also make capital improvements to justify higher rents.

Steve Pomeroy highlighted two important facts in his analysis:

1. New construction involves much higher cost and subsidy than acquiring existing properties that already provide rental housing at similar average market rent levels without subsidy (and don't face the same issues with NIMBY and various delays associated with new development), and
2. The existing relatively affordable properties are being eroded at a faster rate than this high cost new product can be constructed.

As a result, there has been no net gain in the availability of relatively affordable housing in Ontario. Pomeroy concluded that “while new build is needed to prevent housing need worsening, there may be a better way to invest limited funding by allocating grant funding to enable non-profit purchase of existing assets (with appropriate due diligence to select properties in reasonable condition), and thus emulate the behaviour of private investors. While this does not add to supply, it does expand the size and reach of the non-profit sector and helps to preserve affordability.”³² This opportunity will be revisited later in the paper in the discussion of potential policy proposals.

Financers' Economics

“It is more difficult to obtain stand-alone construction financing for rental housing than for just about any other asset class due to the absence of pre-leasing...office, retail, industrial and condo all have pre-leasing or pre-sales. Most bankers aren't keen on 'build it and they will come'...” (PSF)

Obtaining financing on favourable terms was consistently cited by interviewees as the biggest barrier to new rental development. As already indicated, rental projects are complex and risky and all financers have something in common – they will not finance a project unless they are sure that the loan will be repaid with interest.

There are many types of financers and financial intermediaries in real estate development and they differ in areas of specialty, tolerance for risk, and financial returns expected.³³ Fixed-term mortgages on finished buildings are financed by large institutions like big banks and insurers,

31 Prior to 2001, condo developments were taxed at the residential rate while multi-unit rental developments were taxed at the commercial rate which was 3.3 times higher. In 2001, the City of Toronto equalized the property tax on condos and new rental development at the residential rate. The City has a policy that calls for equalizing property tax rates for older multi-unit rental buildings and has been gradually reducing the multi-unit residential tax rate - which declined from 3.29% (of assessed value) in 2001 to 2.20% in 2010, reducing the differential in tax rates between condos and older multi-unit rental buildings from 3.3 times to 2.4 times.

32 See footnote 27.

33 The term “financers” refers to those who raise money to finance projects (e.g., brokers), as well as to the lenders and investors of money.

and large pension funds like OMERS. Fewer large institutions get involved in speculative projects or the risky construction stage, particularly when the economy is weak. Brokers are key intermediaries in construction financing, as they know which investors have money and what it will cost to borrow.

Different financiers make money in different ways. Intermediaries like brokers typically earn fees based on the value of the financing packages or deals that they put together. Financial institutions earn interest on the money they lend. They may also “package” portfolios of mortgages or real estate assets to create financial instruments that they then sell to other investors. These financial instruments can take different forms, some of them very complex, as the credit crisis in 2008 demonstrated.

Successful real estate financiers must be proficient in credit assessment, cost estimation, deal structuring, and creative packaging of assets. They minimize risk by:

- assessing the credit-worthiness of borrowers and the quality of their projects in-depth;
- imposing terms that reduce their risk in the event of default, including ensuring that developers invest significant equity in projects and requiring that loans be insured ;
- passing risk on to investors once the assets are secured.³⁴

Financiers assess credit-worthiness and the quality of projects through the process of underwriting. Residential developments are financed in stages, beginning with the land purchase, and each stage acts as a steppingstone, until the “take-out” mortgage on the finished project. Each lender has its own underwriting criteria to assess financial feasibility and establish loan terms or conditions.

Lenders have common criteria that apply to every stage of development, including their relationship with the developer, the developer’s track record, knowledge of the market, experience with similar projects, the developer’s financial condition, and strong evidence of the sources of repayment. In addition, they use the following assessment criteria and terms or conditions specific to different stages of development:³⁵

- **Land financing** is based on the nature and quality of the proposed development and whether it is appropriate for the location. Lenders require an independent assessment of property value. They also use criteria, such as the loan-to-value ratio (LTV), to determine the level of equity the developer must provide.³⁶ The LTV may be as low as 50% (i.e., loan and equity each at 50% of land value) for a speculative purchase, or as high as 75% (i.e., loan of 75% and equity of 25% of land value) for land that has gone

34 This happens after construction and stabilization, at which point there is a building that can act as security for a loan.

35 This covers the three primary loans (for land, construction, and mortgage), but additional financing is often required to bridge funding timing gaps, or to secure supplementary financing. The additional financing may involve complex, often high-interest, investment structures such as mezzanine lending, which requires extensive financing experience and creativity.

36 The loan-to-value ratio (LTV) expresses the amount of a loan as a percentage of the total appraised value of a property. See the Glossary for more detail.

through pre-development and entitlement and is ready-to-build. Land loans are typically term loans for less than 12 months at a floating rate.

- **Construction financing** is driven primarily by the projected costs of construction. Lenders require detailed schedules of sources and uses of funds that include: the cost of the land loan to be paid off, the hard costs of construction, the soft costs or other project costs, funds to pay interest on loans, and a contingency to cover cost overruns. Financiers may also require a covenant in the loan agreement to protect them against cost overruns by making the developer take the risk. Finally, they usually require CMHC loan insurance, particularly in difficult economic times; CMHC insures construction and long-term financing as one transaction for new rental developments.

Lenders use criteria such as the loan-to-cost ratio (LTC),³⁷ as well as the LTV ratio, to determine how much equity the developer must contribute at the construction stage. CMHC's *Reference Guide* for insuring loans for new multi-unit construction indicates that a loan may be advanced for up to 85% of costs or the lending value, whichever is lower, which means that a developer's minimum required equity contribution is 15% of the project cost. Higher leverage comes at a price as CMHC's fees increase significantly above 75% LTC.³⁸ CMHC also holds back 25% of the loan amount and requires borrower guarantees, which are 100% of the loan amount for new rental buildings, until stabilized rents are achieved. At that time, the guarantee requirement is reduced but is not removed until loan repayments have reduced the LTC to 60%.³⁹ Construction loans are typically term loans at a floating rate for 12 to 36 months.

- **Permanent or mortgage financing** is obtained to pay off the construction loan (unlike condos, where unit sales pay off the construction loan). It typically takes the form of a CMHC-insured mortgage for a five-year term with 25 to 35 years' amortization. As indicated earlier, part of the loan may be held back until the project has achieved stabilized rents, although CMHC might waive the stabilization period for a surcharge of 0.25% of the loan amount. A key consideration in mortgage lending is debt service coverage, which is the amount of operating income available to make mortgage payments. Lenders assess this coverage using a measure called the debt service coverage ratio (DSCR). In rental development, they like to see net operating income exceed debt service by 20% to 30%, which translates to a DSCR of 1.2 to 1.3.

Obtaining mortgage insurance is an added obstacle, as CMHC is the only source for rental housing development and it has its own stringent underwriting criteria and terms. It requires considerable sophistication in underwriting to develop an acceptable application for CMHC insurance. Some interviewees view CMHC's insurance as very costly and its underwriting criteria and practices as opaque, inflexible, and excessively time-consuming – but CMHC insurance not only protects lenders from default, it also provides advantages to borrowers over conven-

37 The loan-to-cost ratio (LTC) expresses the amount of a loan as a percentage of the costs associated with construction through to completion of a building.

38 CMHC's base premium increases from 2.25% of the loan amount for a loan covering 75% of construction costs (75% LTC) to 4.5% of the loan amount for a loan covering 85% of construction costs (85% LTC).

39 After rents are stabilized, the borrower's guarantee is reduced by 2% of the loan for each percentage point by which the LTC ratio exceeds 60%. For example, at 85% LTC the borrower guarantees 50% of the loan amount (the 50% guarantee = [85%-60%] x 2), and at 75% LTC the borrower guarantees 30% of the loan amount.

tional mortgages: reduced equity (15% for insured vs. 25% for conventional mortgages), lower interest rates, longer terms, and therefore the potential for higher returns.⁴⁰

Table 7 uses the for-profit 190-unit rental development example to illustrate a few of the key ratios or measures that financiers consider. This project is conservative, as the operating income is more than typically required to service the debt, as the 1.4 DSCR shows. While the loan-to-cost ratio at 80% would be considered to be high leverage, it is below the 85% maximum. The concept of financial leverage and its benefits and risks is discussed in the next section.

Table 7: Financial ratios for the 190-unit rental development, Year 1 (\$000s)

Debt Service Coverage	
Net Operating Income (NOI)	\$ 3,279
Debt Service Costs	-\$ 2,330
DSCR (NOI/Debt Service)	1.4
Loan-to-Cost	
Debt	\$ 38,159
Developer's Equity	\$ 9,633
Total Project Cost	\$ 47,791
Loan-to-Cost Ratio (Debt/Total Cost)	80%
Source: Affordable housing financial model provided by PD2 and author's analysis	

Benefits and Risks of Financial Leverage

The term “leverage” refers to developers’ practice of minimizing their own equity and using other people’s money as much as possible (within reason) to fund projects. They do this because maximizing their financial leverage, or the percentage of the cost that is funded by debt, increases their returns. Leverage can also free up developers’ money to invest in other projects.

Unfortunately, the benefits of leverage are not guaranteed and too much leverage can be risky because banks and other lenders expect to be repaid, even if a project fails to meet expectations, and lenders have first claim to any profits before a developer’s claim. While lenders have the first claim, it is still in their interests to minimize the possibility of a developer’s defaulting on a loan, hence the use of the measures described earlier, as well as the requirement that developers buy insurance for loans at or above 75% of project cost or value.

Table 8 illustrates the effects of increased leverage on financial returns for the 190-unit for-profit rental development. It compares ROE and IRR for 80% versus 85% debt financing. The developer’s Year 1 ROE increases from 9% to 11% with higher leverage, because the developer has less equity in the project. The internal rate of return if the building is sold after 20 years also increases from 17% to 20% IRR for the more highly leveraged model.

More highly leveraged development is riskier because of the higher cost of debt service. CMHC charges higher premiums for higher-risk loans, increasing its premium in the example from

40 See http://www.cmhc-schl.gc.ca/en/hoficlincl/moloin/molointo/molointo_001.cfm for a sample comparison showing higher return on investment for a CMHC-insured financing versus a conventional (uninsured) financing.

3.5% of the loan amount for 80% leverage to 4.5% of the loan amount for 85% leverage. This additional fee contributes to the higher project cost for the 85% leverage example. The DCSR of 1.3 in the 85% leverage example is still within the acceptable range. That would change if interest rates increased by just one percentage point; both the cash-on-cash return and DCSR would fall below acceptable levels.

Table 8: Financial ratios for the 190-unit rental development comparing 80% versus 85% leverage, Year 1 (\$000s)

Key Variables	80% Leverage	85% Leverage
Debt Service Coverage		
Net Operating Income (NOI)	\$ 3,279	\$ 3,279
Debt Service Costs	-\$ 2,330	-\$ 2,500
DSCR (NOI/Debt Service)	1.4	1.3
Loan-to-Cost		
Debt	\$ 38,159	\$ 40,933
Developer's Equity	\$ 9,633	\$ 8,001
Total Project Cost	\$ 47,791	\$ 48,934
Loan-to-Cost Ratio (Debt/Total Cost)	80%	85%
Return on Equity After Tax; Year 1	9%	11%
Internal Rate of Return if Sell After 20 Years	17%	20%
Source: Affordable housing financial model provided by PD2 and author's analysis		

4. Private-Sector Participation in Affordable Development: Benefits and Barriers

“It is important to ensure sustainable affordable housing stock, but you can’t keep taxing and regulating rental as if it is a business and treat it as a right – not if you want [private-sector] businesses to be involved.” (PSD)

The private sector has long been involved in developing, financing, or operating affordable housing, including non-profit housing. It has been estimated that more than 95% of the capital cost of non-profit housing is paid to the private sector, because the majority of people involved in the work (developers, architects, lawyers, builders, trades, etc.) come from the private sector.⁴¹ Private-sector players get involved only when they can make an acceptable return on their investment of time, money, and expertise, at a manageable level of risk.

Interviewees and reports by industry associations and experts cite a number of benefits and barriers to private-sector participation in affordable rental development.

Benefits of Private-Sector Participation in Affordable Rental Development

The private sector brings the expertise, experience, and scale needed to take on complex and risky projects. The nature of current programs demands considerable expertise in navigating three levels of government, structuring financing from multiple sources, and meeting CMHC’s complicated underwriting criteria which require all assumptions to be verified and sources documented thoroughly. Lack of experience is a big issue in Canada where lack of activity for many years means that there is little experience or expertise in purpose-built rental development or financing – in both the for-profit and non-profit sectors.

The private sector brings valuable discipline. One interviewee, a large U.S. non-profit developer, cited this as the key reason for preferring to partner with commercial banks when undertaking new development as part of the U.S. Low income Housing Tax Credit program. This interviewee has found that commercial lenders and private investors bring an underwriting-like

41 Estimate by Steve Pomeroy, cited in Nick Falvo (2007), “Addressing Canada’s Lack of Affordable Housing,” presentation for the panel on Interdisciplinary Approaches to Economic Issues, Canadian Economics Association Annual Meeting.

discipline to the development of capital and operating budgets and they push his organization to achieve high standards.

The private sector is reportedly more cost-effective, despite the need to earn sufficient profit to compensate for taking on the project development risks. Although it is not surprising that private-sector players would say this, there is evidence from the United Kingdom that risk transference results in lower project costs.⁴² Studies conducted by the U.K. Treasury that assessed outcomes of projects after completion, found cost savings of 17% to 20% versus conventional public procurement approaches.^{43, 44}

Private-sector involvement is seen to be politically favourable. Several interviewees believe that recent government housing programs are focussed, like the private sector, on minimizing risk – which is why they believe governments prefer upfront capital grants to fund projects and to make them viable at lower rents. Others believe that governments feel burned by the long-term commitments they entered into in the 1970s and 1980s and that they do not want to commit to the long-term, ongoing operating subsidies offered in past programs.

Barriers to Private-Sector Participation in Affordable Rental Development

Uncertainty due to lack of long-term commitments by governments to ensuring that every Canadian has an affordable, decent home. One interviewees' company lost a significant amount of money when a major government program was cancelled in the 1980s and they had to shut down projects already under development. They fear it could happen again.

The difficulty of obtaining financing on favourable terms, particularly for construction, where lenders require significant equity investment. Partnerships with non-profits on affordable projects are hampered by non-profits' lack of equity, as Canadian governments expect an equity contribution, similar to U.S. programs. This expectation is viewed as unfair, because Canada lacks the well-developed foundation sector that provides many U.S. non-profits with equity funding for affordable housing.

Government requirements can result in higher construction and operating costs for affordable rental developments making poor economics worse relative to for-profit development.

The irritants that make the pre-development process difficult and time consuming – and inflate costs. The most frequently cited sources of irritation were: CMHC's onerous underwriting criteria and process and the high cost of CMHC insurance; frequent changes in government programs; the lack of consistency between different levels of government (e.g., the previous round of the Canada-Ontario Affordable Housing Program offered a 40-year grant from the fed-

42 A recent TD Economics report, (2006) "Creating the Winning Conditions for Public-Private Partnerships (PPPs) in Canada," asserts that Canadian experience with PPPs is too limited to assess relative cost effectiveness.

43 From TD Economics' report on PPPs cited in footnote 41.

44 Alexandra Moskalyk (2008), "The Role of Public-Private Partnerships in Funding Social Housing in Canada," for CPRN, provides a comprehensive review of opportunities and issues with PPPs including financial benefits. The evidence is mixed and the author suggests there is a "need for caution, vigilance and scepticism," but her case studies "show that social housing can be effectively delivered through partnerships," and "partnerships may have been able to deliver projects that otherwise would not have come to fruition or may have been delivered on a more limited scale."

eral level and a 20-year mortgage from the Province); and the length of time it takes to work with the City to get zoning approvals, building permits, and other permits. Zoning approval alone can take more than a year and cost in excess of \$100,000.

The perception that for-profit players will game the system to maximize their profits. This fear is primarily due to the abuse of past government programs, which some interviewees had experienced first-hand – although these abuses were not limited to the private sector.

In spite of these drawbacks, a number of interviewees expressed positive views of their experiences with the current Canada-Ontario Affordable Housing Program, and in particular with the turnkey approach used in the example of an affordable rental development in the next section.

5. Example Project: Private-Sector and Non-Profit Partnership in Affordable Rental Development

“The ‘hard infrastructure’ and ‘social infrastructure’ need to partner and work hand-in-hand to create healthy and sustainable communities.” (PSD1)

For-profit developers can participate in affordable rental housing projects that receive government subsidies from the Canada-Ontario Affordable Housing Program (AHP) and, when they do so, typically partner or work for a non-profit. A developer who was interviewed for this paper provided a detailed example of the financing and economics for an affordable rental project that is in the process of securing a government grants and other financing.

The example project is a turnkey development in which the developer is partnering with a non-profit and taking the project through predevelopment and construction before turning it over to a non-profit organization, which will then own and operate the building. The project has been designed and built to meet the non-profit’s specifications with input from the developer.⁴⁵ This turnkey approach is considered a “win-win” situation by interviewees because:

- The private-sector developer takes on the development risks (as the specifications and budget are established in advance) and earns an acceptable profit on construction. This is in contrast to alternative arrangements, such as construction management for a fee, which place the risk of cost escalation on the non-profit organization if there is any deviation from project specifications.
- The non-profit organization benefits from the developer’s expertise and experience in working with governments, structuring and negotiating financing, underwriting to meet CMHC’s loan criteria, building design, and managing the construction project cost-effectively.
- The public-sector partner benefits from additional affordable housing stock that will remain affordable longer because of its non-profit ownership.

⁴⁵ There are many other types of private and public partnerships (PPPs). Alexandra Moskalyk (2008) provides a comprehensive framework, successful case studies, and makes policy recommendations to foster and expand formation of PPPs for social housing development.

Below, the economics of the affordable turnkey example are compared to those of the 190-unit for-profit rental development.

Project Cost Comparison: Affordable Turnkey vs. For-Profit Rental Developments

Table 9 compares the costs of similar-sized affordable turnkey and for-profit rental apartment developments.⁴⁶ The total costs are lower for the turnkey development because, in addition to the AHP grant, it benefits from a number of government incentives that reduce costs: below-market land costs, lower debt service costs (government grants significantly reduce the size of the construction loan), and the waiving of municipal development charges and other fees. Hard costs are also somewhat lower for the turnkey project because it uses less expensive finishes than the for-profit project. The combination of the government grants and cost reductions enable the affordable turnkey development to charge significantly lower rents.

Table 9: Project cost comparison: Affordable turnkey vs. for-profit rental development

Costs (\$ 000s)	Affordable Turnkey	% Costs	For-Profit Development	% Costs	\$ Difference FP - TK
Land Costs	\$ 4,000	10%	\$ 8,000	17%	\$ 4,000
Hard Costs	\$ 23,822	57%	\$ 28,930	63%	\$ 5,108
Soft Costs	\$ 3,764	9%	\$ 9,121	20%	\$ 5,357
Total Costs	\$ 31,586	76%	\$ 46,051	100%	\$ 14,465
Source: Affordable housing financial model provided by PD2 and author's analysis					

Financing Program Comparison

Table 10 compares the financing programs for the for-profit and affordable projects. The latter is more complex, because financing had to be secured from a number of sources in addition to government grant programs.⁴⁷ The construction financing for the affordable rental development reflects how much debt the rental income can support which, while considerably lower than the for-profit project, is still significant.

46 The affordable turnkey project excludes developer's profit to allow for direct comparison of project costs.

47 Interviewees have seen even more complex financing structures with a dozen or more funding sources.

Table 10: Comparison of construction financing programs for 190-unit affordable turnkey and for-profit rental developments

	Affordable Turnkey	For-Profit Development
Financing (\$000s):	\$ 41,796	\$ 46,051
Financing Sources	% of Project Costs	% of Project Costs
Equity	1%	20%
Other Government	6%	
Federal Grant	12%	
Provincial Grant	20%	
Construction Financing	61%	80%
Total	100%	100%

Source: Affordable Housing Financing Proposal provided by PD2 and author's analysis

Notes: Affordable project cost includes developer's profit; construction financing includes financing costs and CMHC insurance and fees

Comparison of pro formas

Table 11 compares the pro formas for the affordable and for-profit rental developments.

Table 11: Comparison of pro formas for affordable turnkey and for-profit rental developments (\$000s)

Key Variables	Affordable Turnkey	For-Profit
Operating Pro forma		
Gross Revenue	\$ 2,381	\$ 5,132
Vacancy and Bad Debt Allowances	-\$ 91	-\$ 205
Net Revenue	\$ 2,290	\$ 4,927
Operating Costs	-\$ 785	-\$ 1,649
Net Operating Income (NOI)	\$ 1,505	\$ 3,279
Financing		
Debt	\$ 24,832	\$ 38,159
Equity	\$ 1,000	\$ 9,633
Total Financing	\$ 25,832	\$ 47,369
Debt Service Costs	-\$ 1,505	-\$ 2,330
Debt Service Coverage	1.0	1.4
Profitability		
Cash Flow Pre-Tax (NOI - Debt Service)	\$ 0	\$ 948
Cash-on-Cash Return (Cash Flow/Equity)	0%	10%

Source: Affordable housing financial model provided by PD2 and author's analysis

Note the following differences:

- Revenues are significantly lower, as rent levels for the affordable turnkey development average 80% of market (\$1,000 per unit on average) while rent levels in the for-profit development are 2.25 times the affordable average rents (\$2,250 per unit on average).

- Operating costs are much higher in the for-profit development, because it pays more than \$400,000 in municipal property taxes, from which the non-profit development is exempted. It also has higher operating costs because of higher service expectations (e.g., luxury rental developments generally offer around-the-clock security and have more property management and maintenance support) and higher value (which means higher insurance costs).
- Debt service costs are significantly lower in the affordable development because government grants and CMHC requirements reduce the debt burden; CMHC permits non-profit affordable developments to have a DSCR of 1.0 and still qualify for CMHC mortgage insurance while for-profit developments must have a DSCR of 1.2 to 1.3. A government-qualified lender to a non-profit project will not be concerned about the lack of a cash cushion; they bear no risk because the loan must be insured – and therefore must pass CMHC’s very stringent underwriting criteria in the process.

Rent Level Comparisons and Implications

Table 12 demonstrates why the rent level for the for-profit development needs to be 2.25 times the average affordable rent to generate an adequate return. Returns quickly fall below acceptable levels when for-profit rents fall below 2.25 times the average affordable rent. At about 1.5 times affordable rent, the income from the property is too low to pay for debt service. A for-profit in this situation would be at risk of defaulting on its loans and going bankrupt.

Table 12: Effect of potential for-profit rent levels on value, cash-on-cash return, and ability to secure adequate financing for the 190-unit rental development (\$000s)

Multiple of Affordable Rent	Net Oper. Income by Rent Multiple	Building Value Based on Income	Cash-on-Cash Return	Financing Gap
3.0x	\$ 4,661	\$ 69,572	25%	\$ -
2.5x	\$ 3,740	\$ 55,814	15%	\$ -
2.25x	\$ 3,279	\$ 48,934	10%	\$ -
2.0x	\$ 2,818	\$ 42,055	5%	\$ -
1.5x	\$ 1,896	\$ 28,297	-5%	-\$ 5,242
Affordable	\$ 974	\$ 14,539	-15%	-\$ 20,606

Notes: Affordable is defined as 80% of Median Rent; Building Value is based on a 6.7% Cap Rate on Net Operating Income Pre-tax; Financing Gap is based on a Debt Service Coverage Ratio of 1.2
Source: Affordable housing financial model provided by PD2 and author's analysis

Rent multiples also highlight the magnitude of the gap between what is economic for the private sector and what is affordable to people living in low-to-moderate income. Table 13 shows the gaps between multiples of affordable rent versus the average rent in the 190-unit affordable rental project and the average Ontario Works (OW) shelter rate. At 2.25 times affordable rent, the level required for a for-profit to achieve acceptable returns, the gaps are very large: for-profit rent exceeds the average affordable rent by \$1,251 per month and the average OW shelter rate by \$1,654 per month.⁴⁸

⁴⁸ The gaps between for-profit and affordable rent would obviously grow as a project's affordability increases and rents decline to levels that low-income earners can afford. The model used for the examples could be used to identify the levels of subsidy required to achieve greater affordability. That exercise could be useful to inform dis-

Table 13: Comparison of potential for-profit rent levels, expressed as multiples of affordable rent, vs. affordable rent and Ontario Works (OW) shelter rates

Multiple of Affordable Rent	Potential For-Profit Rents Per Month	Affordable Rent	Gap: F-P Rent Vs. Aff. Rent	OW Shelter Rate	Gap: F-P Rent Vs. OW Rate
3.0x	\$ 3,001	\$ 1,000	\$ 2,001	\$ 597	\$ 2,405
2.5x	\$ 2,501	\$ 1,000	\$ 1,501	\$ 597	\$ 1,904
2.25x	\$ 2,251	\$ 1,000	\$ 1,251	\$ 597	\$ 1,654
2.0x	\$ 2,001	\$ 1,000	\$ 1,000	\$ 597	\$ 1,404
1.5x	\$ 1,501	\$ 1,000	\$ 500	\$ 597	\$ 904
Affordable	\$ 1,000	\$ 1,000	-\$ 0	\$ 597	\$ 404

Notes: Affordable Rent is 80% of Market; For-Profit Rents, Affordable Rent, and OW Shelter Rate are weighted averages by suite size

Source: Affordable housing financial model provided by PD2 and author's analysis

Some experts argue that stimulating *any* rental construction is good because units will “filter down” to low-to-moderate income households and therefore gaps do not need to be eliminated, merely reduced. Offering incentives for the production of units at higher-than-affordable rents would also be less expensive for governments. Unfortunately, filtering takes a long time and can result in poorly maintained housing stock for low-income tenants – if it happens at all.

In gentrifying neighbourhoods, such as those in West-Central Toronto, researchers have observed positive correlations between the age of buildings and household income, or “negative filtering.” Housing economist Andrejs Skaburskis attributes this process to “city growth increasing the attractiveness of central locations which, along with changes in household composition, income and tastes, can reverse the direction of filtering.” The loss of rental stock being experienced in Metro Toronto (see Table 1) will make this trend worse, as the number of units available for filtering continues to decline. Skaburskis’s work not only demonstrates that filtering is not a reliable way to produce affordable housing; it also shows that subsidizing rental development in anticipation of filtering does not constitute a less expensive way for governments to produce affordable housing.⁴⁹

cussion of the relative merits of subsidizing development vs. subsidizing tenants to achieve different levels of affordability.

49 References to Skaburskis’s work from Nick Falvo (2007), “Addressing Canada’s Lack of Affordable Housing.” Presentation to the Canadian Economics Association Annual Meeting.

6. Stimulating More Private-Sector Participation in Affordable Rental

“In real estate everyone always acts in their own best interest. You must create ‘win-win’ situations.” (PS&GU)

The interviewees for this paper made a number of suggestions to stimulate more private-sector participation in developing or helping preserve affordable rental housing. Their proposals are primarily government interventions that improve the economics of affordable development by reducing costs and risk. The proposals share a number of characteristics: a preference for positive versus punitive measures, a preference for policy measures that do not create disincentives to private-sector participation, and a desire for less complex processes and programs.

It is beyond the scope of this technical paper to assess the effectiveness of the ideas, but it seemed wasteful not to capture them. The ideas are grouped according to the following four objectives:

- stimulating more private-sector participation in developing new affordable rental;
- stimulating private-sector financing or investment in affordable housing development;
- ensuring that owners maintain existing, aging affordable rental stock well;
- encouraging private sector owners to sell existing rental buildings to non-profits.

If all of the ideas were assessed, the cost-benefit analysis would probably show that private-sector participation works best for projects affordable to those whose incomes are not far below the average, and that a “menu” of incentives would be required to make it attractive for the private sector to stay involved in developing affordable rental housing.

Stimulating Private-Sector Participation in New Affordable Rental Development

“Government needs to act as a true partner, putting money in sooner to help non-profits get expert support from the start with planning and design, and to deal with ongoing cash flow challenges. And government needs to provide rent supplements for the most needy, because subsidies will never be high enough to achieve rents they can afford.” (NPH)

Interviewees want assurances that the Canada-Ontario Affordable Housing Program's grants for new affordable development will continue – as in the U.S. and U.K., where affordable housing policies and programs have been in place for many years. They made a number of suggestions to improve developers' potential rates of return on affordable rental by helping reduce development costs and speed up the development process.

Provide land at low or no cost. High land costs are the key reason why rental development is not economically feasible in large cities. Land costs could be reduced by:

- Freeing up surplus government-owned land for affordable development, similar to recommendations made in numerous reports, including reports from government organizations and committees.⁵⁰ (Note that this could be difficult to implement in Toronto where surplus land is expected to be sold to generate money for the City.)⁵¹
- Tearing down more of Toronto Community Housing's aging stock and redeveloping the land at higher density, as is being done in Regent Park.⁵²
- Encouraging municipal governments to buy up real estate in gentrifying areas to preserve affordable units.
- Adjusting provincial and federal grant subsidy levels to reflect higher land costs in major urban centres.
- Building affordable housing on leased land, as Toronto's Centre for Addiction & Mental Health (CAMH) is doing. This approach reduces up-front costs, although it does not ensure ownership or operating control in perpetuity. Also, it may not be sufficient on its own to make affordable housing development feasible.⁵³

Reduce developers' cost of capital by having the government provide loan guarantees to developers of affordable rental buildings. The savings will come from lower interest rates, commensurate with the lower risk to financiers, because the guarantee removes the risk of a loan not being repaid. This suggestion is cost-effective for governments, because it requires no cash outlay, as long as clear rules and regulations are in place, including financial criteria, to protect to protect the government from developers' defaulting on loan repayments.

50 Recent reports by the Calgary Committee to End Homelessness (2008), the Federation of Canadian Municipalities (2008), and the Senate's Standing Committee on Social Affairs, Science and Technology - Subcommittee on Cities (2009) all called for use of surplus government lands for affordable housing development.

51 A reviewer of this paper raised a "worrisome" Toronto-specific issue: "Many of Toronto's surplus sites, that would have been subject to 'Housing First' policy in the past, are now being turned over to Build Toronto with a mandate to make money for the City, and an indeterminate promise to negotiate some kind of affordable housing on some of the sites with the Deputy City Manager."

52 The reviewer quoted in the previous footnote also questioned this proposal, as the chance of stimulating net new affordable housing development depends upon how the proposal is implemented. In Regent Park, the additional density is actually being used to build for-profit condos to generate some profit to help subsidize the cost of replacing existing social housing. Regent Park has also received funding from the Canada-Ontario AHP as well as other public investment in community facilities. When the revitalization is complete, there will be less social housing inside Regent Park than before it began, as some of the social housing will be built on nearby land that the City gave to TCHC, outside Regent Park.

53 In the case of CAMH, the lease deal was set up to preserve hospital control of the land, not to facilitate affordable housing development. The affordable residential portion of the CAMH development also required Canada-Ontario Affordable Housing Grants to make building the units economically feasible.

Reduce soft costs by:

- **streamlining environmental assessments and planning and pre-development processes for affordable rental development**, particularly with the municipal governments and CMHC; reducing the pre-construction period not only reduces costs, but also reduces the risk of higher capital costs due to interest rate increases before construction financing is secure;
- **reducing the capital required for construction financing by giving for-profit developers a holiday on development charges**, or the same exemptions that non-profit projects receive, in return for keeping all or some units affordable for a significant time period; some interviewees suggested 20 years, others less as they want to avoid issues with “over-regulating the free market.”

Reduce hard costs of construction by using wood frame construction more often for affordable development. Wood frame construction costs can be as much as 40% less than the costs of high-rise concrete construction.⁵⁴ New methods and materials are making it possible to increase height from the previous four-storey maximum to five or even six storeys, and some jurisdictions have changed or are considering changing building codes to reflect this fact.⁵⁵ The use of wood framing will reduce the density of a development, but could be an appropriate choice for particular sites or projects.

Reinstate past tax incentives that helped make moderately priced rental development financially feasible for private-sector players. Recommendations for tax incentives are pervasive in the literature on affordable housing, likely because they worked in the past. Typical recommendations include: increasing the first year and on-going CCA deductions to 5%, allowing more soft costs to be capitalized, and refunding taxes on new rental construction. There is some question as to whether or not these changes would make enough of a difference today to make rental development economic as land and construction costs have increased considerably over the past decade. This would need to be assessed.

There are two camps with very different views on the relative merits of tax incentives versus the current grant-based approach (see Table 14). Some interviewees believe that both types of incentives should be made available, and that private-sector developers or owners should have the flexibility to choose between them, depending on their circumstances.

54 Potential fire safety issues with wood construction need to be evaluated and addressed.

55 In April 2009 the B.C. government changed its building codes to permit six-storey wood frame construction for residential buildings only.

Table 14: Pros of using grants vs. tax measures to stimulate affordable housing development

Grants	Tax Measures
<p>Department of Finance knows the total expenditure</p> <p>Spending is allocated to the responsible government department</p> <p>Can clearly specify the total amount to be awarded under the program</p> <p>Can be narrowly prescribed or targeted</p> <ul style="list-style-type: none"> • Unlike Tax Measures that the Tax Court often overrides 	<p>Home owners receive huge subsidies through the tax system (e.g. capital gains exemption on sale of primary residences); it is only fair to do the same for renters¹</p> <p>Can limit and target tax incentives</p> <ul style="list-style-type: none"> • E.g. the US Low Income Housing Tax Credit allocates a set amount to each state, which in turn award credits via competitive bid to proposed projects <p>Taxpayers and voters more readily accept tax expenditures than grant programs</p> <p>Tax measures worked before; lack of new build indicates governments went too far in cutting tax incentives</p> <p>Tax Departments are reportedly better at enforcement than Housing Ministries</p>

1. In 2008 the federal government reportedly spent \$76 million on the Affordable Housing Initiative versus approx. \$6 billion annually in tax revenue that is not collected from owners who sell their homes.
Sources: Primarily Don Drummond, of TD Economics, for pros for grants; Marion Steele, Associate Professor Emeritus at the University of Guelph, for pros for tax measures; David Hutchanski's "Canada's Dual Housing Policy; Assisting Owners, Neglecting Renters" for the data in the footnote

Create new tax incentives to stimulate affordable rental development by:

- **waiving capital gains tax on rental developments held for more than 20 years** to improve the developer's rate of return (IRR); while this would reduce government tax revenue, the impact would not occur until after communities benefit from having additional rental accommodation for some time;
- **using the tax system to reduce development costs by creating a refundable tax credit**, possibly one that is analogous to the Ontario Film & Tax Credit Program (OFTTC). The OFTTC is a refundable tax credit based upon eligible Ontario labour expenditures incurred by qualified production companies. It helps attract new business and business investment to Ontario, as well as creating highly skilled jobs. Stimulating affordable rental development would also create jobs, but it is not known if a similar tax incentive program could be designed and implemented at a reasonable cost to government in terms of forgone tax revenue.

Reduce ongoing operating costs by, for example, exempting affordable units from property taxes or giving them breaks on hydro charges. Some interviewees suggested that affordable rental projects should be designed to ensure that the target affordable rent per unit covers the operating costs. This requires consideration of cost/benefit trade-offs and should lead to more cost-effective design specifications.⁵⁶

56 "Green" or energy-efficient development is not considered here, because benefits from reducing operating costs reportedly do not offset the increased costs of construction, so it would not improve a developer's return.

Stimulating Private-Sector Financing or Investment in Affordable Housing

“It’s a myth that all social housing providers are big credit risks. Affordable rental housing will always be in high demand.” (PSF)

Historically, private-sector financiers and investors were involved in affordable rental development. For the most part, however, they were not involved from the mid-1990s to the mid-2000s when the federal government stopped supporting affordable rental housing development. Interviewees made the following suggestions to help bring new investors to the sector:

- **Reinstate the Multi-Unit Rental Building tax incentive program (“but fix the issues with it”).** The MURB tax incentives were used in the mid-to-late 1970s and again in the early 1980s to promote privately owned rental construction by encouraging smaller investors to participate in the market. Owners were allowed to claim a 5% CCA deduction, even if that deduction generated a rental loss, effectively allowing them to write off rental losses against other income. Current regulations allow only Principal Business Corporations (PBCs), whose principal business relates to real estate development, to use CCA losses to reduce income taxes. Smaller investors are no longer in the market. The true effect of the MURB program in increasing rental supply has been questioned and there were reportedly, many abuses. Limiting the tax benefit to new rental development could help address these issues and attract new investors.
- **Create investment vehicles for long-term “patient” investors and socially responsible investors to help finance affordable housing development.** Examples of these kinds of investment vehicles in Canada tend to be community-specific and ad hoc.⁵⁷ In contrast, financial intermediaries in the U. S. and U. K. are actively involved and specialize in affordable housing, the former encouraged by tax measures such as the Low Income Housing Tax Credit (LIHTC) and tax-exempt bonds, and the latter by government subsidies that help make it economically feasible for rental income to service mortgage debt.

It is beyond the scope of this paper to develop or assess potential investment vehicles but much work has already been done in this area. For example:

- Marion Steele and Francois Des Rosiers recently proposed a “made-in-Canada LIHTC that could leverage private-sector expertise in site selection, construction, ownership, and management, to build more and better low-income rental housing.”⁵⁸
- The large U.S. non-profit developer interviewed for this paper has had extensive experience with LIHTCs. Aside from being “more complicated than they need to be,” he finds that they work well in attracting private investors (ideally as true partners) for volume production of below-market rental housing. LIHTC-funded projects are mostly carried out by large, experienced for-profit and non-profit developers, as they are too complex

57 An example of a Canadian investment vehicle is the Alterna Community Alliance Housing Fund, created by a partnership of the Public Service Alliance of Canada’s pension fund, the Alterna Savings Credit Union and the Ottawa Community Loan Fund. It provides low-cost mortgage financing while allowing the pension fund to earn a “patient” five-year GIC rate of return.

58 Marion Steele and Francois Des Rosiers (2009), “Building Affordable Rental Housing in Unaffordable Cities: a Canadian Low-income Housing Tax Credit,” C.D. Howe Institute Commentary No. 289.

for small-scale neighbourhood agencies. He also indicated that the program no longer suffers from the high costs for services of intermediaries (such as syndicators) that were an issue at inception.

- Steve Pomeroy has written extensively on attracting private investment for affordable housing. He believes it should be encouraged because it can build strong private sector backing, as experienced in the U.S. and U.K. – “with private-sector involvement comes increased knowledge and awareness of affordable housing. Because this is good business, members of the financial services community have also become strong advocates for the policy and tax vehicles that facilitate affordable housing development.”⁵⁹

Ensuring that Owners Keep Existing, Aging Affordable Rental Stock Well Maintained

“The role of municipal government should be to bring meaningful financial penalties to bear on investors that own older rental buildings and don’t maintain them. The city has building codes, but likely does haphazard enforcement because it doesn’t have enough inspectors. Maybe if they started enforcing the building codes more effectively and implemented fines, the additional revenue would justify the extra expense.” (PSF)

Owners of aging affordable rental stock include for-profit and non-profit owners – and either one may have poorly maintained stock. For the former, interviewees generally felt that most buildings in private-sector hands are maintained in reasonable condition, but there will always be owners who will not follow the regulations unless forced to do so. They felt that rehabilitating aging, poorly maintained stock would benefit the tenants and attract a broader mix of incomes to rental housing, reducing the concentration and isolation of low-income tenants.

Interviewees favoured a combination of “carrots and sticks” for landlords who fail to maintain their rental buildings. The suggested “sticks” were much stronger enforcement and larger financial penalties. Suggested “carrots,” or positive incentives, included:

- giving owners a tax holiday for two years to help fund rehabilitation to meet regulatory standards and requiring the tax savings to be paid back if the standards are not achieved;
- expediting equalization of taxes for residential condos and older multi-unit rental buildings to improve the economics of owning affordable rental properties and help fund ongoing maintenance; this measure would also correct an inequity in the property tax system which favours owner-occupied housing over rental;
- using the tax savings generated in these ways to create a reserve fund for major repairs in common areas, analogous to the reserve funds that condo corporations are required to maintain under the *Ontario Condominium Act*. This concept needs to be developed further, ideally in a way that avoids the added complexity and costs experienced by many condo corporations in adhering to reserve fund regulations.

59 Steve Pomeroy (2004), “Attracting Private Sector Financing in Affordable Housing,” Tri-Country Conference presentation.

Both non-profit and for-profit owners would benefit from expanding the Federal Rental Residential Rehabilitation Assistance Program (Rental RRAP), which is considered a good program that is under-funded. This program is particularly important for non-profits, as existing funding programs focus primarily on new construction.

Ontario municipalities could target funds generated from financial tools that, under the *Development Charges Act*, may be used for the rehabilitation of affordable rental housing. At a recent affordable housing symposium, Councillor Adam Vaughan suggested that more of Toronto's Section 37 funding be directed to rehabilitation of Toronto Community Housing's rental stock. He asserted that "if 10% of Section 37 money had gone to rehabilitation over the past ten years, there would be no backlog in TCHC's portfolio."⁶⁰

Finally, non-profits need easier ways to refinance their properties to help generate funds for major repairs or rehabilitation of aging stock. Private-sector owners routinely refinance properties to take advantage of growth in income and market value. The *Social Housing Reform Act* of 2000 allowed non-profits to refinance, subject to some restrictions, such as needing permission from the Service Manager, the Ministry of Municipal Affairs & Housing, and the lender. The restrictions and application process reportedly make it difficult for any but the largest social housing providers to take advantage of the benefits of refinancing.

Encouraging Private-Sector Owners to Sell Existing Rental Buildings to Non-profits

"I think it's a great idea for not-for-profits to acquire existing rental buildings and I'm surprised it doesn't happen more often. There is no disincentive for vendors to sell to not-for-profits – if the price offered is right, it wouldn't make any difference to them who the purchaser is." (PSF)

Non-profits should take advantage of the fact that existing buildings are considerably less expensive than new development. Government funds could be productively employed to purchase existing assets, as long as they are in reasonably good condition, emulating private sector investors such as REITs. There are a number of benefits and barriers to non-profit ownership of affordable rental buildings.

- The benefits of non-profit ownership include maintaining affordability over the long-term and providing supports to tenants who need them.
- The barriers to non-profit ownership include difficulty obtaining financing, the unwillingness of for-profit owners to sell due to tax penalties, and the inability to compete with REITs for properties in good condition.

Interviewees suggested two main ways to encourage sales of rental buildings to non-profits:

First, owners of rental buildings should be allowed to defer taxes on capital gains and CCA recapture if they sell to a non-profit and buy another building within a year.⁶¹ Interviewees viewed tax incentives as the best way to encourage for-profit owners to sell to non-

60 Notes are from Kehilla Residential Programme's "Bagels to Bricks Symposium" on February 4, 2010. They refer to Section 37 of the *Planning Act*, which gives the City of Toronto the authority to allow increases in permitted height and/or density in return for community benefits, provided that the benefits fit with Official Plan policies.

61 The suggested incentives are similar to those in Bill C-371, which as of the time of writing was in second reading.

profits as opposed to selling to a REIT or another investor. Allowing tax deferral is consistent with U.S. practice and tax treatment of other capital investments in Canada. For the government, it does not reduce tax revenue; it simply delays the collection of revenue not yet in hand.

Marion Steele has suggested targeting this recommendation by confining it to eligible projects: rental residential multi-unit buildings not registered as condominiums. She also suggested targeting the deferral of CCA recapture by “requiring that the sold building be affordable or the purchased building be affordable (that is, the building must have affordable rents and be occupied for five years by low-to-moderate income tenants).”⁶²

Second, new financing vehicles are needed to facilitate transfer of ownership to non-profits and preserve affordable rental stock. In a recent paper published by the Brookings Institute, author Shekar Narasimhan⁶³ presented a model for a new type of equity financing vehicle that would take the form of a REIT and combine private capital with local, state, and federal resources.⁶⁴ The funds could be used to preserve small-to-mid size multi-unit buildings by facilitating the transfer of ownership from individuals to institutions.

Narasimhan proposed targeting a few cities and testing his idea to determine whether there is local political support for providing tax abatements in return for reinvestment, and whether property owners would be willing to transfer ownership in return for shares in the new type REIT. It would be interesting to determine if a made-in-Ontario version of this model could increase the incentive for ownership transfer while bringing in new investors and investment to help fund rehabilitation and ensure on-going affordability.

62 Marion Steele (2009), “Supply-side Measures to Reduce Renters’ Affordability Problems: Identifying Pros and Cons of Alternative Measures.” Draft for the Calgary Homeless Foundation and the University of Calgary.

63 Shekar Narasimhan (2010), “Why Do Small Multi-Family Properties Bedevil Us?” Brookings Institute.

64 Resources provided by governments could include housing vouchers for tenants who remain in their units for a certain period, which would help ensure affordable rents and stable cash flows.

7. Status and Next Steps

This paper explains the economics and financing of private-sector development of multi-unit rental apartment buildings and shows why it is not economically feasible for the private sector to participate in the creation of affordable rental housing.

Discussion of the paper started several months ago, when a draft was distributed to the interviewees for comment. A revised draft was then distributed to various constituencies including the Neighbourhood Change CURA members; other academic experts; for-profit, non-profit and public-sector participants in affordable housing development and financing; housing policy experts; and affordable housing advocates. Three consultations were held to review and discuss the paper. A number of those who read the paper provided feedback at the consultation meetings, while others sent their comments directly to the author. The feedback has been incorporated in the paper.

The immediate next step is for Neighbourhood Change CURA to distribute the paper more broadly. The text may also be tailored for different audiences with different levels of understanding of real estate finance and different areas of interest with respect to the provision of affordable housing. Additional meetings or consultations are being considered to discuss and debate the findings. Appendix III contains questions to help guide discussion and debate.

More work could also be done to assess the effectiveness of the various suggestions for stimulating private-sector participation in affordable rental housing. Most of the ideas are not new. Any assessment must therefore build on the significant body of work already done by academics, governments, associations, and other experts while bringing a private-sector perspective to bear on the analysis and findings.

Glossary

Assets are anything of value, such as real or personal property. Assets may be appropriated for the non-payment of debt.

Basis point is a measure of the percentage point change in value or rate of a financial instrument, such as changes in bond yields or interest rates. One basis point equals 0.01% (1/100th of a percent).

Bridge loans are used to bridge funding gaps, such as carrying a project while a permit is being sought, or to take advantage of a short-term opportunity such as quickly closing on a site before securing longer-term financing. They are often considered to be speculative or risky and are therefore more expensive than regular loans. They are typically made by individuals or businesses that make a practice of offering higher-interest loans. Bridge loans on a property are typically paid back when the property has been sold or refinanced with a traditional lender, or when the borrower's credit-worthiness improves, or when the property is improved or completed.

Capital cost allowance (CCA), according to Revenue Canada, is “a tax deduction that Canadian tax laws allow a business to claim for the loss in value of capital assets due to wear and tear or obsolescence.” The percentage deduction varies depending on the asset class. The CCA for new rental buildings is 2% in the first year and 4% in subsequent years. It is calculated on a declining basis, which means that the base for the calculation is net of the CCA from the prior year, and deductions continue until the building is fully depreciated (that is, the cost on the books has been reduced to zero). For example, if a building's original value was \$50 million, the CCA would be:

Year 1 – 2% x \$50 million = \$1 million

Year 2 – 4% x \$49 million (\$50 million – \$1 million) = \$1.96 million

Year 3 – 4% x \$47.04 million (\$49 million – \$1.96 million) = \$1.88 million

...and so on...

The CCA deduction is expensed before income tax is calculated, which means that it helps reduce taxable income and therefore improves financial returns. This is why increasing the CCA rate is often recommended as a means of stimulating more rental production.

Capitalization rate (cap rate) is the percentage used to determine or assess the market value of a property based on its estimated future net operating income (see the definition of this term below). Cap rates are determined based on an appraisal of recent sales of similar properties. Real estate service companies, like Colliers International, publish cap rates for major markets on a regular basis. The cap rate is a simple and useful tool for valuing real estate. Two examples of uses of cap rates follow:

- For valuing property, where property value = net operating income/cap rate. If a rental property produces net operating income of \$100,000 per year, and the market cap rate is 7%, the value of the property (what one would expect to pay to buy it) is:
 $\$100,000 / .07 = \$1,428,571$.
- For determining whether a property investment will generate the desired returns, where property value x cap rate (or investors' required return) = net operating income required. If a rental property is being sold for \$100,000 and the market cap rate is 7%, an investor would expect the property to generate net operating income of at least \$7,000 ($\$100,000 \times .07$).

Cash-on-Cash return (CoC) measures the ratio between anticipated first year pre-tax cash flow to the amount of initial cash investment (equity) made by the developer, financier, or real estate investor for building or purchasing a rental property. CoC is expressed as a percentage. Its shortcoming is that it does not take into account the time value of money as it measures a residential income property's first year cash flow only and not its future year's cash flows. CoC is most useful as a quick and easy way to compare the profitability of income-producing properties or to gauge a real estate investment against another investment opportunity.

Covenant strength for the purposes of getting a loan refers to the financial worth or financial strength of the potential borrower as opposed to the value of the asset being financed.

Debt is the amount owed for money borrowed. Generally, debt is secured by a note, bond, mortgage, or other instrument that sets out interest payments and repayment terms. The note, in turn, may be secured by a lien against property or other assets.

Debt service is the amount of payment (to cover interest and principal or loan amount) due regularly to meet a debt obligation; usually a monthly, quarterly or annual payment.

Debt service coverage ratio (DCSR) is the primary measure used to determine if a property will generate enough cash flow to pay its debts on an ongoing basis. The DCSR is calculated by taking the net operating income (see definition below) and dividing it by the property's annual debt service, which is the total amount of interest and principal paid on the loans against the property throughout the year.

If a property has a DCSR of less than one, the income it generates is not enough to cover mortgage payments and operating expenses. For example, a property with a DCSR of 0.8 only generates enough operating income to cover 80 percent of annual debt payments. A property that has a DCSR of more than 1.0 generates enough operating income to cover annual debt payments. For example, a property with a DCSR of 1.5 generates 50% more operating income than is required to cover its debt payments. Most commercial banks require a DCSR of 1.2 to

1.3 for multi-unit residential development to ensure cash flow is sufficient to cover loan payments on an ongoing basis.

Default is the failure to discharge a duty such as failing to pay off a mortgage or other loan, or failing to comply with the terms of a loan.

Equity is the value of property in an organization or a real estate development over and above the total debt it holds. Equity investments typically take the form of a share in a business, and often, a share in the return or profits. Equity investments carry greater risk than debt and the potential for greater return should compensate for the added risk.

Financial leverage is a measure of a company's ability to meet its financial obligations. Companies that are highly levered may be considered to be at higher risk of bankruptcy if they have trouble meeting their re-payment obligations. The appropriate amount of leverage varies for different businesses and, if not excessive, can provide better returns as well as tax advantages. Real estate development tends to be a high leverage business. In Canada, if a borrower contributes less than 25% of its own equity and borrows 75% or more of the value of the property, the loan must be insured by CMHC to protect the lender against default.

Hard costs for construction include the contractor, construction labour, raw materials, environmental clean-up, landscaping, and other construction-related costs.

Internal rate of return (IRR) is a measure of percentage return from the initial investment that takes into account the timing and scale of projected future cash flows. For rental real estate it measures what the future income stream from a rental property is worth today. Timing is important as a dollar in hand today is more valuable than one five, ten, or twenty years from now.

IRR is considered acceptable if it exceeds the owner's or investor's cost of capital, or some minimum generally acceptable rate of return. The actual calculation is complex and typically done using special software or a financial calculator. Key variables include the initial investment (present value), cash flows by period, and the future value of the investment. There is added complexity in determining IRR for rental real estate as the future value must be adjusted to account for selling costs, taxes on capital gains and taxes on recapture of CCA deductions. The example in the section on Owners' Economics illustrates how these adjustments are made.

Loan-to-cost ratio (LTC) is another measure of financial leverage. It expresses the amount of a loan as a percentage of the total costs associated with construction through to completion. For instance, if a developer wants \$9 million for constructing a project that will cost \$12 million in total the LTC ratio is \$9 million/\$12 million or 75%. The LTC is used to assess risk in the construction phase in conjunction with the loan-to-value ratio (see below) because it is difficult to value an apartment building that is not yet built.

Loan-to-value ratio (LTV) is another measure of financial leverage. It expresses the amount of a loan as a percentage of the total appraised value of a property. For instance, if a developer wants \$20 million to develop a property worth \$25 million, the LTV ratio is \$20 million /\$25 million or 80%. The LTV is one of the key risk factors that lenders assess when qualifying borrowers as a high LTV ratio means there is a higher the risk of a borrower defaulting. Lenders typically require borrowers of high LTV loans to buy mortgage insurance for protection in the event

of buyer default which increases the cost of the mortgage. An LTV ratio over 75% is generally considered high and requires CMHC mortgage insurance.

Mezzanine loans are often used by developers to secure supplementary financing for development projects (typically in cases where the primary mortgage or construction loan equity requirements are larger than they want to fund with their own equity). Mezzanine loans are often unsecured (that is, not backed by assets) and lenders demand very high interest rates (e.g. 18% to 20%) in return for the risk involved.

Net operating income (NOI) is the total rental income from a building minus any income lost due to vacancies, and minus all operating expenses. Financial projections for new developments typically assume a vacancy rate of 2% to 3% on average meaning that the rental income will likely be reduced by that amount.

Pre-sales threshold is the percent of units sold that is necessary to obtain construction financing and is typically 60% to 70% of the number of units in a condominium. It can also be the threshold at which condo developers can close unit sales.

Pro formas present data, typically financial statements, which have assumptions or hypothetical conditions built into them, such as a projection of rental income, operating expenses and expected profits used to demonstrate the viability of a project to potential lenders.

Recourse refers to the right, in an agreement, to demand payment from the person who is taking on an obligation. A “full recourse” loan means the lender has the right to take any of the borrower’s assets if the loan isn’t repaid. A “limited recourse” loan only allows the lender to take assets named in the loan agreement. A “non-recourse” loan limits the lender's rights to the particular asset being financed – an approach common in home mortgages and other real estate loans.

REIT stands for Real Estate Investment Trust. A REIT is a security that sells on stock exchanges. REITs were first offered in Canada in 1993. They are required to be configured as trusts and do not pay income taxes if they distribute their net taxable income directly to shareholders, who then pay taxes on that income. There are different types of REITs:

- Equity REITs invest in and own and operate properties, earning money primarily from rental income.
- Mortgage REITs invest in and own mortgages on property. They may loan money to property owners for mortgages or purchase mortgages or mortgage-backed securities, earning money primarily from the interest on mortgage loans.

Return on equity (ROE) is another measure of financial performance. It compares profit with the amount of capital (equity) employed to generate it by dividing profit by equity. It combines elements of both risk and return (profit or income less expenses) and increases as profits increase. It also increases as equity decreases because the equity investor has taken on less risk. Real estate developers will try to increase return and decrease their equity contribution to maximize their ROE. ROE differs from cash-on-cash return in being calculated on after-tax income (as opposed to pre-tax).

Soft (development) costs include all other costs for development and construction that are not considered hard costs, such as design, sales and marketing, financing, and administration.

Standby fee is a fee paid to the lender for committing to make a sum of money available at specified terms for a specified period. It is generally intended to be replaced by another commitment; for example, construction financing is replaced by long-term mortgage financing when a building is ready for occupation.

Underwriting is the process of determining the financial feasibility and the terms of a project. The objective of underwriting is to determine whether the ongoing revenue from a property will be sufficient to cover construction and operating costs. There is no one “right” way to do underwriting. However, across all approaches, underwriters must consider some common elements for multi-residential developments:

- project costs for construction, to determine reasonableness and eligibility;
- sources of financing for the project;
- projected profitability and financial health of the project using measures like the loan-to-cost and debt service coverage ratios described above;
- financing and operating terms.

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Appendix I: Interviewees and Expert Contacts

The following list indicates the Sectors and Reference Codes of interviewees:⁶⁵

Two Private Sector Real Estate Developers: PSD

Six Private Sector Real Estate Financers: PSF

One Private Sector Real Estate Manager: PSM

Four Private Sector Specialists (e.g. cost estimator, legal expert, etc.): PSS

Two Private Sector and Government Underwriters: PS&G

Two Municipal Government Affordable Housing Staff: MG

Two Provincial Government Policy Analysts: PG

Two Non-profit Real Estate Developers: NPD

Three Non-profit Housing Advocates: NPA

Three Academic Experts: AE

⁶⁵ Interviewees and contacts are characterized and labelled by sector and profession, borrowing from the approach used by Julie Mah in her recent paper for CPRN: "Can Inclusionary Zoning Help Address the Shortage of Affordable Housing in Toronto?"

Appendix II: Private-Sector Perspectives on the Neighbourhood Change CURA’s Proposals

The Neighbourhood Change CURA (Community University Research Alliance) developed a set of policy options with the following objectives:

- maintain affordable housing and prevent displacement of existing residents;
- maintain affordability of existing rental housing;
- add new rental housing;
- maintain a mix of local businesses and services.

Ten actions to achieve these objectives are listed in Table 15. More detail on the proposals can be found on CURA’s website, <http://www.urbancentre.utoronto.ca/cura/>.

Table 15: Neighbourhood Change CURA’s policy objectives and potential actions to achieve them

Maintain Affordability and Decrease Displacement	Add New Rental Housing	Maintain Local Business and Service Mix
Expand RRAP	Made-in-Toronto Approach to Inclusionary Zoning	Support Small Neighbourhood Businesses
Reinstate Energy Efficiency Program for Low-income Households	Remove Zoning and Regulatory Barriers to Affordable Housing	Build Community Capacity
End Vacancy Decontrol	Use Taxation Powers to Fund Affordable Housing Directly	
Prevent Conversions of Rental Buildings With Less Than Six Units		
Protect and Promote Good Quality Rooming Houses		

Interviewees commented on some of the Neighbourhood Change CURA’s proposals. These perspectives are set out briefly below for proposals designed to maintain affordability and to stimulate the addition of new rental housing. Some views are mixed or not favourable, but the

Neighbourhood Change CURA's policy objectives and actions were not aimed at providing incentives to increase private-sector participation in affordable development or financing.

Views on Neighbourhood Change CURA's actions to maintain affordable housing and prevent displacement of existing residents:

- **Expanding the Rental RRAP program to fund more projects was viewed favourably.** It is seen as a program primarily for the smaller landlords prevalent in the West-Central Toronto study area. It could also be very useful for non-profits in rehabilitating rental stock if some government funding is redirected to acquiring older buildings to maintain affordability.
- **Reinstating the Energy Efficiency Program for Low income Households has no direct impact on the private sector.** Some interviewees suggested that a better approach would be to simplify the more than 50 current programs and integrate them better across different levels of government, rather than adding or reintroducing another program. The coherent simplified program could have a component that targets low-income households.
- **Ending vacancy decontrol was seen to be a disincentive for the private sector.** Interviewees felt that ending vacancy decontrol would worsen the economics of rental. Some questioned the need, as they believe that rent levels have stabilized – according one interviewee, “it would be a yawn if Ontario ended rent control today.” While generally the case, this unfortunately may not apply to gentrifying areas where more targeted measures are believed to be needed. Regardless, interviewees do not believe there is much political will to end vacancy decontrol and felt that advocacy efforts would be better directed to proposals that are more likely to be acted upon.
- **Preventing conversions of rental buildings under six units was viewed as unnecessary.** No one believed that anyone would invest in converting a building smaller than 20 units, given the high cost, because it would not be economically feasible. This action would also create untenable obligations for small property owners. Expediting equalization of property taxes on older multi-unit buildings with residential property taxes would be an easier way to eliminate the benefits of conversion and is consistent with the City of Toronto's policy. Before accepting this logic, there is a need to ensure it applies to gentrifying areas.

Views on Neighbourhood Change CURA's actions to add new affordable rental housing:

- **Implementing inclusionary zoning was not viewed favourably, but interviewees suggested that such a measure should be designed to reduce negative consequences.** Their primary concerns were that inclusionary zoning could result in restrictions on resale and title that would depress the value of properties, and that it makes new developments more difficult to manage and market. Some believe that setting the inclusion level too high will “sterilize” a lot of land when the economy changes – and the recommended 20% level was considered too high. If developers have no choice and inclusionary zoning is made mandatory they would want the following:

- the combination of affordability level, inclusion requirement, and incentive (e.g., density bonus) must produce their normal profit margin or return on equity;⁶⁶
 - the playing field must be level, with the same base requirements and incentives for all, so they know the cost and can build it into their financial assessments and, if possible, offset the added cost by paying less for land;
 - the inclusion requirement should be reduced to 5%, or to not more than 10%;
 - the definition of “affordability” must take into account the specific neighbourhood or area of the city;
 - there must be flexibility to adjust the size and quality of affordable units; e.g., as in San Diego, where affordable housing is mixed with market rate housing in new developments;⁶⁷
 - price appreciation must be allowed for affordable ownership so that homeowners can build equity.
- **Removing zoning and regulatory barriers to affordable development was viewed favourably**, particularly if these actions reduce costs and expedite approval processes. There was some concern about actions being too specific. For instance, recommending a set parking minimum was seen as simplistic. Parking should be site-specific based on a needs assessment (including proximity to transit and employment). Instead of a parking minimum, consideration could be given to requiring that affordable housing be near transit, which would reduce the need for parking and fulfil other policy objectives. Reduced parking, however, is not the only way to reduce costs. The City could offer breaks on hydro bills or help find other means to get operating costs down, as appropriate for the site and project. There was agreement that affordable housing should fit the neighbourhood to avoid stigmatizing tenants.
 - **Using taxation powers to fund housing directly met with mixed reactions.** The idea of dedicating 1% of City property taxes to affordable housing initiatives sounds reasonable. But in Ontario municipalities are responsible for partially funding and delivering social housing and other social services. The property tax base is paying for that service already. A property tax levy would also be onerous for older multi-unit rental buildings, which already pay 2.4 times the residential property tax rate.

66 John Gladki and Steve Pomeroy (2007), “Implementing Inclusionary Policy to Facilitate Affordable Housing Development in Ontario,” demonstrated that developers could earn reasonable returns (15% margin on ownership or 8% to 12% return on equity for rental) by including 15% affordable housing units in return for a 25% density increase, targeting households in the 40th income percentile. They cautioned against deeper targeting for rental properties as “this can act as a deterrent to rental supply when the economic feasibility is already quite tenuous, especially when competing for land against condominium ownership products.”

67 Steve Wright (2007), in “Pros vs. Cons: Smart Growth experts debate inclusionary zoning strategies in an effort to win diverse affordable neighbourhoods” indicated that in typical San Diego developments, single-family homes are market rate and developers team up to build garden-style rental apartments or condominiums to fulfil the affordable requirement.

Appendix III: Potential Questions to Guide Discussion and Debate

Potential questions for discussion relate to the suggested proposals for policies and programs to stimulate private-sector participation in developing or maintaining affordable rental housing. This technical paper and next steps (if any) for the work could also be topics for further discussion.

With respect to policy and program discussion and debate:

- Should stimulating more private-sector participation in affordable housing development and financing be a policy objective? If so, what actions or combinations of actions should take priority?
- Should the funding envelope be modified to provide for purchasing existing buildings and rehabilitating them for affordable rental? If so, what actions should take priority?
- How should policy recommendations and actions be shaped to increase effectiveness at addressing needs in gentrifying areas?

With respect to this technical paper and next steps:

- Is this paper useful and for what purposes?
- Is the presentation of the economics of key players clear and understandable, even to those with little exposure to real estate finance?
- Should it be simplified and tailored for different audiences? If so, what audiences?
- What are the next steps, if any, in developing this work further?