MEMORANDUM

coriolis CONSULTING CORP.

DATE: 9 July 2019

TO: Edna Cho, City of Vancouver

FROM: Blair Erb, Coriolis Consulting Corp.

RE: **Summary of Preliminary Key Findings for Phase 1 of Financial Analysis for Market Rental Policies**

The City of Vancouver retained Coriolis Consulting Corp. to analyze the financial performance of market rental apartment development under current market conditions to determine the effectiveness of existing incentives available to new rental developments and to test potential changes to rental policies. The work was divided into two phases. Phase 1 evaluates the impact on the viability of new rental apartment projects of:

- The existing rental incentives offered by the City (increased permitted density, City-wide DCL waiver, Utilities DCL waiver).
- Off-site utility infrastructure upgrades.
- A right-of-first refusal for existing tenants at rental buildings that are approved for redevelopment.
- Rental-only zoning (at C2 sites).
- Rent control at unit turnover (vacancy control).

The preliminary analysis for Phase 1 has been completed and the key findings are summarized in this memo. Future work during Phase 2 will explore a variety of other new rental policies that could be considered by the City.

In Phase 1, we modelled the likely financial performance of new rental apartment development at a cross-section of different types of sites that have been the focus of rental development over the past several years. We examined twelve sites in different neighbourhoods in the City (some on the East Side and some on the West Side). Sites were selected from a variety of different existing zoning districts, including the C1, C2, C3A, RM3, RM4, RS and RT districts. For each site, we tested the economics of apartment development at rental densities that have recently been achieved in these zoning districts.

The key findings of our preliminary analysis for Phase 1 can be summarized as follows:

1. If the City wants developers to create new rental housing:
    - Development needs to be financially attractive.
    - Sufficient profit is required in order to obtain project financing and address the costs and risks associated with new development. Typically a minimum profit margin of about 15% is required by multifamily residential developers to obtain construction financing and proceed with a new project. However, in specific circumstances, some developers may elect to proceed at a lower margin. For example: in order to mitigate capital gains taxes, long term owners of a property may elect to redevelop at a lower margin rather than sell; developers interested in creating a portfolio of rental properties may accept a lower margin if suitable existing rental properties cannot be purchased; and developers who originally planned a strata project may elect to proceed with a rental project if they are concerned about short term market risks.
2. For sites currently zoned C1, C2, C3A, RM3, RM3A and RM4:

- Even with the existing incentives (and no off-site utility upgrades), market rental apartment development only generates an estimated profit margin in the range 7% to 11% at the sites that were tested. This is significantly lower than the typical profit margin required by most multifamily developers to obtain construction financing and proceed with a new project. It is also lower than the profit margin that can likely be achieved through strata development (under existing zoning).
- Each of the existing rental incentives currently offered by the City helps close the financial gap between market rental development and strata apartment development. Of the existing incentives, the largest positive impact is from increased permitted FSR, followed by the City-wide DCL waiver and the utilities DCL waiver. However, even with all of these incentives, strata residential development is still the most profitable type of housing development at each of the sites that were tested.
- The existing rental development incentives offered by the City (increased density, DCL waivers) are likely required to make market rental development financially attractive for the vast majority of developers. The utilities DCL waiver has the smallest positive impact of the incentives currently offered, but it is an important part of the overall package of incentives.
- Any requirement to fund off-site utility upgrades (separately from the utilities DCL) negatively affects the financial viability of new market rental development. The negative impact depends on the cost of upgrades required and size of the rental project. The impact can be large on smaller projects.
- In the absence of the existing incentives offered by the City, we would expect developers to build more strata housing and much less new rental housing in these zoning districts, resulting in less new rental housing supply over time. A reduction in new rental supply will result in lower vacancy in the market and put upward pressure on rents at units throughout the City (in both new rental buildings as well as units in existing rental stock).

3. For sites currently zoned RS and RT:

    - If it is permitted, market rental apartment development can be financially attractive at the densities the City asked us to test, if the existing rental incentives are offered.
    - Depending on the permitted density, some RS and RT sites may not require all of the existing incentives in order for rental development to be financially attractive. The exception appears to be RS sites in East Vancouver which may require all of the existing incentives.
    - A requirement to fund off-site utility upgrades negatively affects the financial viability of new market rental development at these types of sites. The impact depends on the cost of upgrades required and the size of the rental project.

4. The City is interested in examining rental-only zoning in the C2 district. There are different approaches to rental-only zoning that can be considered. If the City downzones existing C2 sites to only allow rental use (removes the existing strata development rights), it will reduce the land value of C2 sites (unless there was a very large off-setting increase in permitted rental density) and negatively affect existing property owners. In addition, although rental-only zoning will reduce C2 land values, it will not reduce market rental rates. The implications for the viability of new rental development will vary depending on the site:

    - Rental-only zoning will not improve the financial viability of new rental development at C2 sites where the value of the existing improvements is similar to, or higher, than the site’s land value as a strata development site. This is likely the current situation at most C2 sites in East Vancouver. Therefore, we would not expect rental-only zoning to improve the financial viability of rental development at most C2 sites in East Vancouver.
    - Rental-only zoning will improve the financial viability of new rental development at C2 sites where the value of the existing improvements is significantly lower than the existing land value as a strata development site. This could be the case at many of the C2 sites on the West Side of Vancouver that are improved with older low density buildings (say single storey). Therefore, it is possible that rental-only zoning could improve the financial viability of rental development at C2 sites on the West Side.

However, it is important to note that the rental-only zoning improves viability only because the rental-only zoning would reduce property values for these sites. This will have a significant impact on existing property owners. At reduced values, existing owners may choose to hold sites rather than sell for redevelopment.

An alternative approach that could improve the financial viability of rental development and mitigate any negative impacts on existing C2 property owners is to introduce zoning that retains the existing C2 density for strata projects, but permits increases in residential density for rental projects (through a rental-only density bonus). This may require tall concrete buildings.

5. A right of first refusal (at below market rents) to existing tenants who are displaced due to redevelopment will have a financial impact on the rental developer. The impact depends on:

- The number of existing units that are demolished (fewer units results in less negative impact of profit).
- The percentage of tenants that return to the new rental building (fewer returning tenants results in less impact).
- The length of time the returning tenants remain in the new building (less time results in less impact).
- The rents that the returning tenants can be charged (lower rents results in increased impact).

It is not possible for a developer to accurately estimate the impact in advance due to the number of variables that are uncertain. The impact could be small or it could be large. Lenders will likely assume the largest financial impact which makes it more challenging for a rental developer to obtain project financing.

6. The Residential Tenancy Act (RTA) restricts annual rent increases to the Consumer Price Index (CPI) until a tenant vacates the unit (until 2018, the RTA allowed annual rent increases of CPI plus two percentage points). At turnover, rents are permitted to be increased to market. CPI is typically lower than the annual increase in market rents. If rent increases were also restricted to CPI at turnover (vacancy control), it would have a large negative impact on the financial performance of new rental development because:

- The value of the newly completed rental building would be significantly reduced due to lower potential rents over time.
- Property taxes and other operating costs incurred by the building owner (these have historically increased at a faster rate than CPI) could increase at a faster pace than rents, resulting in lower income over time.

We would expect rent control at unit turnover to make market rental development financially unattractive, likely resulting in a large decline in new rental housing supply over time.

A reduction in new rental supply will result in lower vacancy in the market and put upward pressure on rents at any unregulated units throughout the City.