MEMORANDUM

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DATE: 16 November 2019

TO: Edna Cho, City of Vancouver

FROM: Blair Erb, Coriolis Consulting Corp.

RE: **Rental Incentives Review Phase 2: Summary of Key Findings of Financial Analysis**

1.0 Introduction

The City of Vancouver retained Coriolis Consulting Corp. to analyze the financial performance of hypothetical market rental development projects in different locations and different zoning districts in the City as input to helping evaluate potential changes to existing rental development policies. The analysis we completed can be grouped into four different categories:

1. Evaluating the financial viability of secured market rental apartment development at different assumed heights and densities at sites currently zoned C2, RS and RT in the absence of incentives (other than increased density).
2. Evaluating the impact of possible incentives on the financial viability of secured market rental apartment development, including:
   a) City initiated rezoning (prezoning) to allow rental development at increased height and density in the existing C2, RS and RT Districts[1].
   b) Waiving the City-Wide and Utilities DCLs (these incentives are already available to qualifying projects).
   c) Providing a ten year property tax exemption to new rental projects through a Revitalization Tax Exemption (RTE).
   d) Eliminating GST on new rental development projects (this would need to be implemented by the Federal government).
   e) Allowing up to 40% of new rental buildings (at C2 sites) to be used for tech enable hospitality units (hotel units).
3. Evaluating the impact of possible new development requirements on the financial viability of secured market rental apartment development, including:
   a) Requiring rental projects to achieve higher green building standards, such as Passive House or Step Code 4 (with electric and heating and hot water).
   b) Requiring rental apartment projects (in existing RT or RS districts) to include below market rental units at Moderate Income Rental Housing Pilot Program (MIRHPP) rents.
4. Evaluating the impact of requiring strata projects in the C2 District to replace any existing rental units that are demolished as part of redevelopment (i.e. rental replacement).

The key findings of our analysis are summarized in this memo.

[1] Our analysis assumes that any change in zoning would still permit the existing uses at the existing permitted densities. In addition, rental apartment would be permitted at increased permitted density.

2.0 Context

If the City wants private developers to create new rental housing, then rental development needs to be financially attractive. This means that developers planning new projects need to think the project will generate sufficient profit to obtain project financing and address the costs and risks associated with new development.

Most strata residential developers target a minimum profit margin of about 15% on total project costs as this is typically required to obtain construction financing and proceed with a new project. Discussions with lenders (and developers) indicate that a similar profit margin is usually required to proceed with a market rental project. Having said this, in specific circumstances, some rental developers may elect to proceed with a new project at a lower anticipated profit margin. For example:

1. In order to mitigate capital gains taxes, long term owners of a property may elect to redevelop at a lower margin rather than sell.
2. Investors that interested in creating a portfolio of rental properties and have access to necessary capital may accept a lower development margin if suitable existing rental properties cannot be purchased.
3. Developers who originally planned a strata project may elect to proceed with a rental project if they are concerned about short term market risks.

However, when planning a new project most rental developers will target a profit margin of about 15% on costs. If the anticipated profit is too low, developers may elect to proceed with other options such as strata development.

3.0 Financial Viability of Rental Development at C2, RS and RT Zoned Sites

3.1 Sites Zoned C2

1. Market rental apartment development generates an estimated profit margin in the range 4% to 9% at the sites we tested without rental incentives (other than increased density), assuming densities in the range of 3.3 to 3.7 FSR. This is lower than the typical profit margin required by most developers to obtain construction financing and proceed with a new project. It is also lower than the profit margin that can typically be achieved through strata development (under existing zoning).
2. Incentives are likely required to make market rental development financially attractive at C2 sites for the vast majority of developers.
3. In the absence of rental incentives at C2 sites (such as the existing DCL waivers offered by the City), we would expect developers to build more strata housing and much less new rental housing, 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).

3.2 Sites Currently Zoned RS or RT

1. Market rental apartment development generates an estimated profit margin in the range 0% to 15% at the sites we tested, assuming densities in the range of 2.0 to 2.4 FSR without incentives (other than increased density). For most of the sites we tested, the estimated profit margin was less than 9% which

is lower than the typical profit required by most developers to obtain construction financing and proceed with a new project.

2. At densities in the 1.2 to 1.45 FSR range, estimated profit margin ranged from zero to 3% at the sites we tested (in the absence of incentives).
3. Our analysis indicates that some RS and RT sites may be financially attractive for rental development in the absence of incentives (primarily large existing lots with low existing property values per square foot of site area), but this is highly sensitive to the permitted density. Incentives (in addition to increased density) are likely required to make market rental development at RS and RT sites financially attractive for the vast majority of developers and sites.

4.0 Impact of Incentives

The incentives that we tested all have a positive impact on the estimated profitability of market rental development. The impact varies slightly depending on the overall permitted density, the location of the property, the size of the project and the existing zoning district. The results can generally be summarized as follows:

1. **Prezoning**. If the City zoned sites in advance for rental development (i.e., prezoning) so that applicants were not required to go through the rezoning process, the estimated profit margins at the sites we tested would increase by about 1 to 2 percentage points (for example an 8% profit margin increases to 9% or 10%) because the applicant would not incur the costs associated with rezoning (application fees, consultant fees) and the holding costs on land acquisition would be reduced due to a shorter approvals process. In addition, to this estimated positive impact on profit, prezoning would significantly reduce the risks and uncertainties associated with rezoning and would allow projects to be brought to the market more quickly. Reduced approvals uncertainty and risk are not are not reflected in the financial analysis; however, these would be significant benefits to an applicant.
2. **DCL Waivers**. The City already provides DCL waivers to rental projects (but these incentives are not reflected in the base case results in Section 3.0). The combined positive impact of the City-Wide DCL waiver and the Utilities DCL waiver on the estimated profit margin of a rental apartment project is between 2 and 4 percentage points depending on the project density and location (as DCLs vary based on density and location). The DCL waivers have a significant positive impact on the financial viability of rental development. The Utilities DCL waiver accounts for about 1 to 2 percentage points of the total 2 to 4 percentage point impact.
3. **Property Tax Exemption**. If the City provided a ten year property tax exemption to a new rental project through a Revitalization Tax Exemption (RTE), the estimated profit margin would increase by about 1 to 2 percentage points.
4. **GST.** If the Federal government eliminated GST on new rental development projects, the estimated profit margin would increase by about 4 to 6 percentage points. This has the largest positive impact on rental development viability of all of the incentives tested.
5. **Tech Enabled Hospitality**. Some jurisdictions are allowing rental apartment units to be used as tech enabled hospitality units (the units are operated as hotel units for tourists). Examples of tech enabled hospitality companies are Sonder and Lyric. If rental projects in the C2 district were permitted to use about 40% of the new units in the building (i.e. 2 floors of 5 residential floors) as tech enable hospitality

units, the estimated profit margin for the project would increase by about 2 percentage points (the total positive impact is actually about 4 percentage points, but the project would not quality for the DCL waiver which brings the overall net positive impact down to 2 percentage points).

Exhibit 1 shows the estimated profit that a market rental project would generate in the absence of any incentives (other than increased density) and the estimate impact on the profit margin of each of the different incentives that we tested.

Exhibit 1 – Summary of Estimated Impact of Incentives on Rental Profit Margin

	C2 Sites at 3.3 to 3.7 FSR	RS and RT Sites at 2.0 to 2.4 FSR	RS and RT Sites at 1.2 to 1.45 FSR
Estimated Profit Margin Without Incentives	4% to 9%	zero to 15%	zero to 3%
City-Wide DCL Waiver	+ 2%	+ 2%	+ 1%
Utilities DCL Waiver	+ 1% to 2%	+ 1% to 2%	+ 1%
Revitalization Tax Exemption	+ 2%	+ 1% to 2%	+ 1% to 2%
GST Exemption	+ 5%	+ 4% to 6%	+ 5% to 6%
Tech Enabled Hospitality (40% of units)	+ 2%	not analyzed	not analyzed

5.0 Impact of New Requirements on Rental Projects

The potential new requirements that we tested for rental projects all reduce the estimated profitability of a new market rental project, making rental development less attractive. The impact varies slightly depending on the overall permitted density, the location of the property, the size of the project and the existing zoning district. The results can generally be summarized as follows:

1. **Passive House**. If rental projects are required to achieve Passive House, the estimated profit margin at the sites we tested decreases by between 1 and 4 percentage points depending on the density scenario and form of development (the impact is actually larger, but the City offers a 5% FSR bonus if Passive House is achieved, which helps off-set some of the negative impact).
2. **Step Code 4**. If rental projects are required to achieve Step 4 of the BC Energy Step Code (with electric heating and hot water) the estimated profit margin at the sites we tested decreases by about 1 to 3 percentage points depending on the density scenario analyzed and form of development.
3. **Below Market Rental Units**. If rental projects at RS and RT sites are required to allocate 10%[2] of the residential floorspace to below market rental units (at MIRHPP rents), the estimated profit margin at the sites we tested decreases by about 3 to 9 percentage points depending on the density scenario analyzed. If the below market unit requirement is higher, then the decrease in profit would be larger.

Exhibit 2 shows the estimated profit that a market rental project would generate in the absence of any incentives (other than increased density) and the estimated impact on the profit margin of each of the different new requirements that we tested.

[2] This ratio was selected for illustrative purposes. The City could set a higher or lower below market unit requirement.

Exhibit 2 – Summary of Estimated Impact of Potential Requirements on Rental Profit Margin

	C2 Sites at 3.3 to 3.7 FSR	RS and RT Sites at 2.0 to 2.4 FSR	RS and RT Sites at 1.2[3] to 1.45 FSR
Estimated Profit Margin Without Incentives or New Requirements	4% to 9%	zero to 15%	zero to 3%
Passive House	- 2% to -4%	- 2% to -4%	- 1% to -4%
Step Code 4 + Electric	- 2%	- 2%	- 1% to -3%
MIRHPP (10% of residential)	not analyzed	- 3% to -6%	- 5% to -9%

6.0 Impact of a Rental Replacement Requirement at C2 Sites

The City asked us to evaluate the impact of introducing a requirement for new strata apartment projects at C2 sites to replace any existing rental units that are demolished as part of redevelopment. A requirement to include new rental units within a strata project will reduce the land value that a developer can afford to pay for a development site because the completed rental units have a lower value than a strata unit (although costs are similar). Therefore a rental replacement requirement would reduce existing land value for C2 sites. The impact on land value will vary depending on the number of rental units that need to be replaced due to demolition so the impact is not consistent across all sites.

1. Based on our analysis, we would expect the land value of most C2 sites with existing rental units (typically in mixed commercial and rental apartment building) to decline by roughly 10% to 25%, depending on the location of the property and the number of existing rental units at the site. It should be noted that this does not necessarily mean that a property's overall value will decline as it may currently be more valuable as an income producing property than as a development site. If so, its market value would continue to be based on the income stream generated by the existing improvements (which would be higher than land value).
2. If C2 land values decline, it will mean that fewer sites are financially attractive for strata redevelopment. This will not mean that more sites are financially attractive for rental development as (in the absence of incentives), the value of C2 properties will continue to be higher than the land value supported by rental development (as the existing use at C2 sites will still support a high value). Therefore, with a rental replacement requirement, more C2 sites will be retained in their existing use.
3. In addition to the potential impact on land value, a rental replacement requirement would likely also create less interest in strata development due to the requirement to create mixed tenure buildings with a small number of rental units. This increases the complexity of the development process, but it is not accounted for in our analysis.

Overall, we would expect a rental replacement policy to reduce C2 land values and lead to less new strata apartment development in the C2 District.

[3] The MIRHPP scenario was not analyzed for 1.2 FSR townhouse scenario so the estimated impact is for the 1.45 FSR scenario.

7.0 Evaluation of Potential Policy Direction

The City asked us to provide comments on the likely impact on the pace of rental development and the impact on land values of the rental policy directions it is considering. This section summarizes our preliminary comments[4].

Our understanding is that the City is considering the following policy direction for market rental projects:

1. Amending the C2 District to allow mixed use rental densities in the range of 3.3 to 3.7 FSR with a requirement to meet Step Code 4 plus electric heating. Projects would continue to be eligible to receive the City-Wide DCL waiver (subject to meeting rent rate conditions for the first tenant), but would not receive the Utilities DCL waiver.

   Amending the zoning will have a positive impact on the viability of rental development and reduce some of the time and risks associated with rental development. However, the requirement to pay the Utilities DCL and meet Step Code 4 will off-set the financial benefit of the City's zoning amendment. Overall, we would expect projects to achieve slightly lower profit margins than currently achievable under the City's rezoning policies for C2 sites. However, the uncertainty associated with rezoning will be eliminated which reduces project risk and reduces the approvals time frame. Overall, we would expect rental development interest in the C2 zone to continue to be similar to current levels. We would also expect no upward influence on development site values.

2. Creating a new zoning district(s) that applicants can rezone into for specific RS and RT locations along arterials. In blocks on arterials with existing commercial space, the new rental zoning district(s) would allow two options including:

   - 2.5 FSR mixed use with a requirement to meet Step Code 4 plus electric heating. Projects would be eligible to receive the City-Wide DCL waiver (subject to meeting rent rate conditions for the first tenant), but would not receive the Utilities DCL waiver.
   - 3.3 to 3.7 FSR mixed use with a requirement to meet Step Code 4 plus electric heating and a requirement for 20% of the residential floorspace allocated to below market rental units. Projects would be eligible to receive the City-Wide DCL waiver, but would not receive the Utilities DCL waiver.

   At these densities, we think it is possible for mixed use rental projects to achieve profit margins generally in the range of 7% to 13%, depending on location and permitted density. At these profit margins, we would expect some developers to be interested in this option. However, interest will be site specific and will depend on the actual achievable density. Over time, interest will likely increase if rental rates continue to increase. If implemented in a significant number of locations, this should help increase the pace of rental development in the City.

   In blocks on arterials without existing commercial space, the new rental zoning district(s) would allow two options including:

   - 2.0 to 2.2 FSR residential or (depending on whether the location is a commercial location) with a requirement to meet Step Code 4 plus electric heating and hot water. Projects would be eligible to receive the City-Wide DCL waiver (subject to meeting rent rate conditions for the first tenant), but would not receive the Utilities DCL waiver.

[4] Any estimates of potential profit margins are based on preliminary analysis and should be treated as approximate.

- 2.6 FSR residential with a requirement to meet Step Code 4 plus electric heating and hot water and a requirement for 20% of the residential floorspace allocated to below market rental units. Projects would be eligible to receive the City-Wide DCL waiver, but would not receive the Utilities DCL waiver.

At these densities, we think it is possible for rental projects to achieve profit margins generally in the range of 1% to 8%, depending on the location and permitted density. This is significantly less profitable than the mixed use options due to the lower assumed density and may only be attractive to developers in limited circumstances. To encourage more rental development, we would suggest examining the opportunity to increase the permitted density in this option.

Given the relatively modest achievable profit margins, we would not expect any significant upward influence on the value of existing RS and RT properties.

3. Creating a new zoning district that applicants can rezone into for specific RS and RT locations off of arterials to allow 4-storey rental densities up to 1.75 FSR with a requirement to meet Step Code 4 plus electric heating and hot water. Projects would be eligible to receive the City-Wide DCL waiver, but would not receive the Utilities DCL waiver. At this maximum density our analysis indicates that profit margins would likely be very low, so other than in unique circumstances (e.g., lots with low existing land value per square foot), we would expect little interest from developers in this option in the foreseeable future. We would also expect little or no upward influence on property values due to this policy.