Housing Market Digest

Greater Toronto Area, October 2024

Land Values

During 1997 to 2000, I worked at a boutique real estate consultancy. Most of my work was doing feasibility studies for potential residential developments. Mostly, I was assessing market parameters (pricing, but also product characteristics). Sometimes, I did financial feasibility analysis.

In the financial feasibility work, the objective was usually to calculate the "residual land value", which is: expected revenue minus expected construction costs, soft costs, a reserve allowance, and a profit target. The mantra in those days was "land value is always a residual".

I think that has to be fine-tuned, to "a builder should never pay more than the residual value for land".

In the current situation, I expect that calculated residual land values should be a lot lower than two years ago (and earlier):

- The sharp rise in interest rates has reduced the prices that can be paid by buyers (owner-occupants and investors).
- Government-imposed costs (development charges, etc.) have increased a lot.
- Hard and soft costs probably haven't fallen materially. (In fact, the cost of construction finance has increased a lot.)
- Therefore, there is much less residual available for land value.

Today, the more salient issue is: how many land owners are willing to sell for the residual values and how much land supply is being offered at those reduced values?

Well, that depends on the expectations, goals, and financial capacities of the land owners. In a lot of situations, these considerations aren't creating much pressure to sell land:

- There seems to be a widespread expectation that the GTA housing market will remain highly pressurized, and that while homes sales are weak and pricing has softened, there will be stronger conditions in future.
- The land owners are often private companies, and their decision-making is about getting the best outcomes over long periods of time (decades, not years).
- How much does it cost to hold onto raw land (in terms of realty tax, interest costs, management expenses, opportunity costs of invested capital, etc., minus revenues that can be generated by that undeveloped land). How many land owners are experiencing pressures that cause them to sell at lowered expectations?

It appears that for low-rise sites there are few land sales happening at present. Many of the owners are being patient and aren't offering sites at the current (much reduced) residual values.

On the other hand, data published by Bullpen Research & Consulting (https://bullpenconsulting.ca/) and Batory Management indicates that for apartment sites, current estimated values (on a per buildable square foot basis) are lower than during 2018 to 2021 (there are enough high-rise transactions to generate estimates). There are suggestions that those land sales are often out of necessity (financial distress).

Depending on locations, contrary to that old mantra, land value isn't always determined by the residual that can be calculated from the expected selling prices of the housing. In some places (especially in the GTA, and especially for low-rise sites), the arrow points in the other direction - home values are influenced by exogenous costs, including the price expectations of the land owners, as well as government-imposed costs. And, because of the way the housing market works, those exogenous costs for new homes affect prices for resales.

In terms of creating affordable housing opportunities (that is, reducing prices for new homes, and consequently in the existing homes market), costs of creating new housing need to fall (or interest rates need to return to the extreme lows seen earlier). But,

- While interest rates have farther to fall, it's highly unlikely that they will fall by enough to support current pricing.
- Hard and soft costs of construction aren't likely to change a lot.
- It would be great for land values to fall, but there is no guarantee that will happen.
- The best real opportunity is to substantially reduce government-imposed costs (even so, eliminating them completely would only be a partial solution).

Another possibility is what we might call "economic decentralization", but there isn't very much happening on that front. I'd like to see the federal and provincial governments lead the way on this, by maximizing remote work, so that a lot of their work forces can live in lower-cost places. This is something useful that they could actually do. But, to have a material impact, it would have to happen on a really large scale.

Interest Rates

Bond yields have fallen by a considerable amount, and 5-year fixed mortgage rates are now about three-quarters of a point lower than during the first half of the year.

Resale Activity

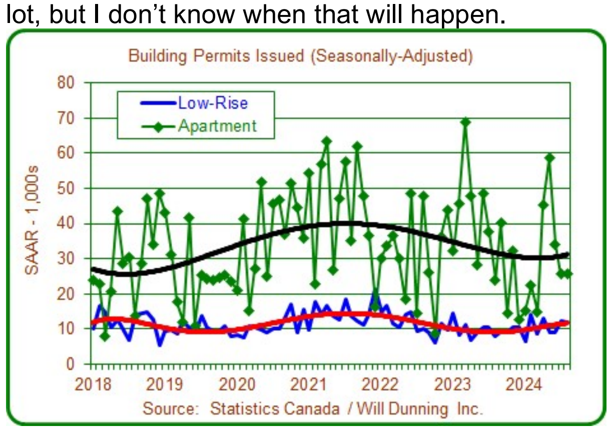
This rate reduction should be enough to cause a substantial increase in the sales rate, but for September the annualized rate (66,000) was only slightly above the recent average (63,900 during the prior three months). September sales were still 41% below the long-term population adjusted average (for all of Canada, the shortfall is 17%).

Listings also expanded. The sales-to-new-listings ratio remains very low (35%, which is far below the balanced market threshold of 52%). Prices remain flat, which I take to mean that few owners are being forced to sell involuntarily.

New Construction

Toronto housing starts have been quite weak for two consecutive months (an annualized rate of just 22,500 for September). I'm still inclined to see this as just noise in the data (due to lumpiness in the data for apartments), and not a turning point. That said, we are making no progress against the enormous cumulated supply deficit.

The recent lull in apartment starts reflects a low volume of building permits issued early this year. I still expect that apartment starts will fall by quite a lot, but I don't know when that will happen.



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