Market Commentary

FALL 2022

Rising Rates, A Boon for Moderate Growth Markets

Recovery from the pandemic has been marked by two important macro-economic drivers: high inflation, and the ensuing central bank responses to high inflation through quantitative tightening. The current North American inflation rate is at its highest level in four decades, and the rate of new interest rate hikes are unprecedented. For multi-family REITs, these factors raise questions regarding the resulting impact to capitalization (cap) rates and asset allocation.

The last two decades have seen a general trend of cap-rate compression in the multi-family sector, but as rates rise and inflation persists, concerns over the longevity of this trend are surfacing. Overall, there is minimal research on cap rate performance during periods of rate hikes and high inflation. A study by S&P Global finds that REITs have traditionally outperformed other asset classes over the last 25 years[1]. The same S&P study finds that over sustained periods of rising interest-rate hikes, ranging from 1976 to 2006, there is little evidence of correlation between rate-hike environments and REIT performance[2]. Additionally, the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index shows that historical periods of elevated inflation are positively correlated to increased returns, indicating that concerns of declining asset performance during high inflationary times are largely unfounded[3].

In many ways, today's macro-economic paradigm mirrors that of the 1970s, with high inflation and rapid interest-rate increases. But the current setting is entirely different given that the cadence of these hikes is faster overall and follows the period of historically low rates of the pandemic[4]. This recent low-rate environment has allowed for impressive asset appreciation due to a low cost of borrowing, and strong demand for new units. Today's environment poses unique challenges, as demand is still robust, even as rents remain high as a function of rent-to-household income. The impact to cap rates and asset valuations remains to be seen, but if past rate hike cycles are a reliable indicator, the impact will be muted.

Preserving Cap Rates and Asset Valuations

In an environment of economic uncertainty or a recession with rising interest rates – preserving cap rates is paramount for overall fund performance. In a challenging financial setting, asset values could be at risk due to declining liquidity in the marketplace, ability to source debt and equity, and increased competition from higher yielding products[5]. Maintaining cap rates in a setting with downward pressure on asset values can be resolved by optimizing Net Operating Income (NOI).

Capitalization Rate = Net Operating Income / Asset Value

Boosting NOI is a function of increasing the revenue being generated from operations while reducing overall expenses. For multi-family assets, generating rental-rate growth is core to growing NOI and maintaining asset performance.

Increasing Rental Income in a Challenging Environment

Increasing rents in an environment where residents are feeling the pinch of economic uncertainty may seem akin to swimming against the current. The nature of housing expenses, however, whether they be in the form of a mortgage or rental payment are not substitutable goods – housing is a necessity which must be budgeted for.

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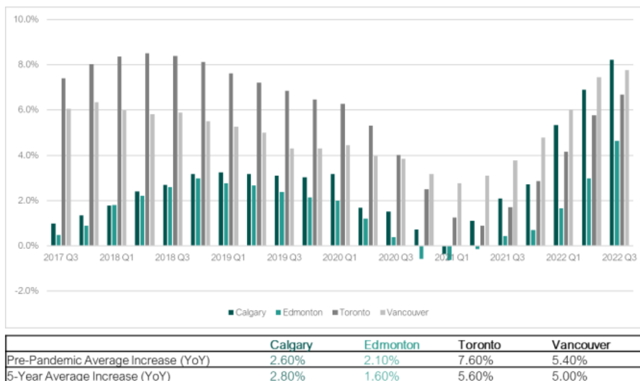
The ideal benchmark for affordability of housing is typically set at 30% of monthly gross household income[6]. In higher cost markets, where rental payments are near or exceed 30% of gross income, the ability for an asset owner-operator to raise rents to increase rental income is limited due to a renter's ability to pay. Exerting additional pressure on a financially strained renter may result in a loss of that resident – in a competitive setting, replacing that renter could prove challenging. Figures 1 and 2, using data from CoStar[7], demonstrate rental rate growth over the last five years on a quarterly basis, using Calgary and Edmonton as examples for higher affordability, and Toronto and Vancouver as lower affordability markets.

Figure 1: 5-Year Market Asking Rent Growth



	Calgary	Edmonton	Toronto	Vancouver
Pre-Pandemic Average Increase (YoY)	2.60%	2.10%	7.60%	5.40%
5-Year Average Increase (YoY)	2.80%	1.60%	5.60%	5.00%

Source: CoStar

The Ability to Perform with Steady Income Growth

In environments where a high proportion of renters are at or near the affordability ratio threshold of 30%, every potential increase to rental rates creates additional financial stress.

This can lead to the resident not renewing their lease and renting elsewhere. In turn, a vacant unit with a higher rent-to-income ratio for potential renters is harder to lease, and thus may remain vacant for longer, weighing down on the building's NOI on an annual basis.

Net Operating Income (NOI) = Effective Gross Income (EGI) – Operating Expenses

Traditionally, operating environments with higher affordability (<30%) are better equipped to avoid the issues above, as assets are purchased with conservative financial assumptions for rental rate growth. That growth is reflected through income-producing potential, and asset values through higher cap rates. Theoretically, slower rental rate growth is thus reflected in a more moderate NOI growth rate.

To maintain a cap rate – faster rent growth needs to be maintained to generate the momentum to grow NOI at the financial forecasted rate. When market factors create faster acceleration in rent growth, higher affordability markets are better positioned to absorb the required increases through small hikes – which minimize the impact to a renter's capacity to pay.

Case Study: Scenarios for Rental Rate Growth in Four Key Markets

When evaluating the dynamic between slower and faster rent growth environments, Table 1 breaks down the impact of declining affordability based on rent increase momentum. The table compares markets in Calgary, Edmonton, Toronto, and Vancouver based on respective median renter household income data from CMHC's 2020 'Real Average Household Income by Tenure' report[8] and average 2-bedroom rental prices were selected to be representative of 2-bedroom units in a B-Class asset within a 5km radius of the downtown core for each market using data from Rentals.ca, Zumper, and Rentfaster.ca[9]. Sensitivity for affordability is added in 5%, 10%, and 15% YoY rental rate increments, with each increment demonstrating further strains in household affordability.

The initial 5% increment is considered conservative based on recent momentum of post-pandemic rental rate increases. In lower growth markets where rental prices have grown more progressively in the past 5-year window, the 5% increase translates to an additional monthly payment of $70/60 per month for renters in Calgary and Edmonton respectively, maintaining the affordability ratio below 30%. With a more considerable increase, at 10%, these two markets would see average monthly increases of $140/120 per month respectively while maintaining the affordability ratio below 30%. Even in the more extreme scenario of a 15% - the affordability thresholds are kept at sub-30%.

With the current annualized rent-to-income ratio, both Toronto and Vancouver are well above the 30% ratio when using the median renter household income and the average 2-bedroom rental price. The situation is worsened with 5%, 10%, and 15% yearly increases. At 5% and 10% increases, a household in Toronto would be faced with a $125 and $249 monthly increase, spending around 60% of its gross household income on rent. While the situation is less severe for Vancouver, the $118 and $237 monthly increases would further strain the affordable rental scenarios outlined below.

Table 1: Case Study, Annualized Rent to Income Ratio

	Calgary	Edmonton	Toronto	Vancouver
Current				
Median Renter Household Income	$ 69,500.00	$ 66,000.00	$ 53,900.00	$ 66,900.00
Average 2 Bedroom Rental Prices	$ 1,412.00	$ 1,208.00	$ 2,498.00	$ 2,370.00
Annualized Rent to Income Ratio	24.4%	22.0%	55.6%	42.5%
5% Increase in Rental Prices				
New Average 2 Bedroom Rental Prices	$ 1,482.60	$ 1,268.40	$ 2,622.90	$ 2,488.50
New Rental Price Increase	$ 70.60	$ 60.40	$ 124.90	$ 118.50
New Annualized Rent to Income Ratio	25.6%	23.1%	58.4%	44.6%
10% Increase in Rental Prices				
New Average 2 Bedroom Rental Prices	$ 1,553.20	$ 1,328.80	$ 2,747.80	$ 2,607.00
New Rental Price Increase	$ 141.20	$ 120.80	$ 249.80	$ 237.00
New Annualized Rent to Income Ratio	26.8%	24.2%	61.2%	46.8%
15% Increase in Rental Prices				
New 2 Bedroom Rental Prices	$ 1,623.80	$ 1,461.68	$ 3,022.58	$ 2,867.70
New Rental Price Increase	$ 211.80	$ 253.68	$ 524.58	$ 497.70
New Annualized Rent to Income Ratio	28.0%	26.6%	67.3%	51.4%

Source: Statistics Canada, CMHC

In an environment with widespread market cap-rate decompression – preserving asset valuations requires an increase in NOI. If an industry standard NOI margin of 60% can be maintained, then EGI needs to grow through yearly rental-rate increases, as detailed above. Table 2 breaks down the low- and high-end cap-rate standards for Low Rise B-Class assets for each market.

Table 2: Case Study, Annualized Rent to Income Ratio Growth

	Calgary	Edmonton	Toronto	Vancouver
Current Low Rise B Class Cap Rate				
Low	4.50%	5.00%	3.00%	3.25%
High	5.00%	5.75%	4.00%	4.00%

Source: CoStar

Adding in sensitivity analysis for the required gains in NOI required to maintain asset values is detailed in Table 3. Sensitivity for the overall impact of decompressing cap rates is broken down in 25, 50, and 75 bps increments. The overall impact for each 25-bps increment in cap rate decompression is expressed through the required NOI increase required to maintain current asset valuation.

Assumptions:

- 25 units per asset is held as a constant across all markets.
- An NOI margin of 65% is a constant across all markets.
- Median price per unit (Low Rise B-Class) is used to determine the final asset value assuming a constant of 25 units per asset.

In Table 3, the initial increment is considered conservative at 25 bps. In the selected lower growth markets below, the more aggressive 50 bps increase, the higher the EGI, which can translate to an additional monthly payment of $39/30 per month for renters in Calgary and Edmonton respectively, maintaining the affordability ratio below 30%. With the highest increase, at 75 bps, these two markets would see average monthly increases of $78/60 per month respectively while maintaining the affordability ratio below 30%.

As previously shown, both Toronto and Vancouver are well above the 30% ratio when using the median renter household income and the current average two-bedroom rental price. The situation is further impacted by the incremental increases displayed in Table 3. With increases of 25 and 50 bps, a household in Toronto would be faced with a $104 and $208 monthly increase respectively, spending over 60% of their gross household income on rent. In the case of Vancouver, affordability would be similarly impacted, though to a lesser extent with affordability at >45%.

Table 3: Case Study, Annualized Rent to Income Ratio Growth

	Calgary	Edmonton	Toronto	Vancouver
Current				
Current Low Rise B Class Cap Rate (Low)	4.50%	5.00%	3.00%	3.25%
Average 2 Bedroom Rental Prices	$ 1,412.00	$ 1,208.00	$ 2,498.00	$ 2,370.00
25 Bps Increase				
New Low Rise B Class Cap Rate	4.75%	5.25%	3.25%	3.50%
New Fair Asset Value Loss (%)				
Required EGI Increase to Maintain Value	$ 47,066.67	$ 36,240.00	$ 124,900.00	$ 109,384.62
Required NOI Increase to Maintain Value	$ 15,296.67	$ 11,778.00	$ 40,592.50	$ 35,550.00
Required Monthly Rental Rate Increase	$ 78.44	$ 60.40	$ 208.17	$ 182.31
50 Bps Increase				
New Low Rise B Class Cap Rate	5.00%	5.50%	3.50%	3.75%
New Fair Asset Value Loss (%)				
Required EGI Increase to Maintain Value	$ 47,066.67	$ 36,240.00	$ 124,900.00	$ 109,384.62
Required NOI Increase to Maintain Value	$ 30,593.33	$ 23,556.00	$ 81,185.00	$ 71,100.00
Required Monthly Rental Rate Increase	$ 156.89	$ 120.80	$ 416.33	$ 364.62
75 Bps Increase				
New Low Rise B Class Cap Rate	5.25%	5.75%	3.75%	4.00%
New Fair Asset Value Loss (%)				
Required EGI Increase to Maintain Value	$ 70,600.00	$ 54,360.00	$ 187,350.00	$ 164,076.92
Required NOI Increase to Maintain Value	$ 45,890.00	$ 35,334.00	$ 121,777.50	$ 106,650.00
Required Monthly Rental Rate Increase	$ 235.33	$ 181.20	$ 624.50	$ 546.92

Source: CoStar. Notes: The low end of cap rate standards for Low Rise B-Class assets is used as a baseline for all current cap rates.

Starting with a higher baseline of current cap rates, the selected lower growth markets of Calgary and Edmonton require significantly lower per month rent increases in order to meet the required increase in NOI with each incremental 25 bps cap rate increase.

Conversely, the impact to rental-rate increases is far greater in the higher-growth markets of Toronto and Vancouver, which each use progressive 25 bps increase as the starting point, while cap rate baselines were lower. When compounded with the current paradigm of low affordability, the impact of each 25 bps increase is significant to the end user, as they need to pay an ever-higher percentage of their household income towards rent.

Outcomes

How can a household cope with a 5% or 10% increase in rent when faced with an already high annualized rent-to-income ratio? A household may choose to stay and endure the increases, for the time being – or they may move to downsize, find a lower priced building, community, or town, or consolidate households. All three scenarios result in the same impact to the owner-operator: vacancy. Higher vacancy results in lower EGI, which in turn negatively impacts NOI. With lower NOIs, cap rates will begin trending in the wrong direction. Rental affordability impacts the financial well-being of residents, but it also allows for a market where increases of 5 or 10% are feasible without crossing over the 30% rent-to-income ratio, while boosting rental income to meet NOI targets and ensure cap rates trend favourably. Similarly, in an environment with decompressing cap rates, owners can achieve meaningful percentage increases in NOI through small rent increases, lowering the burden on the renter and facilitating better outcomes. The disproportionately negative impact on affordability in higher growth markets proves to offer upside to moderate-growth regions, as small rent increases yield material improvements in maintaining asset valuation.

NOTES & CITATIONS

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