Assessment of the CMHC Rental Construction Financing Initiative: A New Opportunity for Non-Profit Providers

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Prepared on May 30, 2017
Updated on July 17, 2017

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Executive Summary

In April 2017, CMHC formally provided the details for a new lending initiative, which was first announced in the 2016 federal budget. The Rental Construction Financing initiative (RCFI) seeks to encourage the construction of moderate rent rental housing across Canada. It is important to note that this initiative is primarily a mechanism to stimulate new rental construction. While including some affordability criteria as a quid-pro quo for some preferential features it is not intended as an affordable rental program. Nonetheless, it offers an important option to non-profit housing corporations interested in constructing moderate-market rent properties.

This brief reviews and assesses the potential of this new initiative to stimulate new purpose built rental construction. It also highlights an implementation issue, which may require CMHC attention and refinement.

The RCFI offers favourable financing rates and terms to proponents including non-profit, municipal and private developers, with up to $625 million in loans each year (over the next four years), starting in 2017.

In order to qualify for this favourable financing, developers must propose viable projects meeting a range of affordability, energy and accessibility criteria. Key among these are requirements to reduce rents 10% below full market potential; achieve a minimum 15% decrease in energy use and greenhouse gas emissions relative to the 2015 model building codes; and design at least 10% of the project's units to meet or exceed accessibility standards for the municipality. These requirements will add some costs to construction, but may be compensated by improved marketability of units (e.g. accessible units may appeal to an aging demographic, energy efficiency will lower tenant utility costs).

Two illustrative pro formas were adapted from previous work to examine how the initiative may work in Toronto (a high cost-high rent market) and Halifax (a more average cost-average rent market).

The assessment found that by far the most beneficial features of the RCFI are the potential to borrow up to 100% of cost with up to a 50-year amortization period. Combined, and individually, these features are far more significant than the relatively small reduction (75-100 BPS) in the interest rate (since all rates are currently already very low). Overall, the analysis concludes that the Rental Construction Financing initiative may be quite effective in attracting investment and stimulating construction of purpose built rental housing.

Given the minimal equity requirement, this financing initiative may be especially beneficial for entrepreneurial non-profit providers seeking to become more financially sustainable by adding mixed rent and market rent units to their social-affordable portfolio.

There are, however, some implementation challenges. Most notable among these is the affordability criteria to encourage a portion (20%) of units to have lower more affordable rents.

A review of the rent levels that would result based on using the proposed 30% of local household income appears to generate higher rents than intended – often higher than the rents recently achieved in new private market rental developments (and higher than the required 10% below market potential for other 80% of units). Accordingly, it is recommended that CMHC revisit and consider refining the proposed criteria. Non-profit providers can of course voluntarily adopt a more targeted criterion, even without CMHC changes (and the modeling in this brief assumes a target of 20% of rents at 100% of Average Market Rent)

Second, the requirement to establish rents at a below market potential without any targeting or selection criteria may help to create moderate rent opportunities, but will not necessarily result in matching the units with moderate income households who might best benefit from the public financing initiative. Again, non-profit providers may choose to add some eligibility criteria in tenant selection for the 20% affordable units).

1. Introduction

In April 2017, CMHC formally provided the details for a new lending initiative, which was first announced in the 2016 federal budget. The Rental Construction Financing initiative (RCFI) seeks to encourage the construction of moderate rent rental housing across Canada. It provides loans on favourable terms, as described below, to proponents including non-profit, municipal and private developers, with up to $625 million in loans each year (over next four years), starting in 2017.

The CMHC website provides details on the lending program including a viability tool here: https://www.cmhc-schl.gc.ca/en/hoficlincl/moloin/mupr/rental-construction-financing.cfm

This brief reviews and assesses the potential for this new initiative to stimulate new purpose built rental construction. As well as opportunities for investors and developers, including for profit and not for profit proponents to benefit from the initiative.

Key elements of loans

- Rates are below market, utilizing the federal government crown borrowing facility. Currently this will provide financing over a 10 year term at rates that are roughly 75-100 basis points below those attainable under the most competitive CMHC insured loans.
- The loan covers both constructions financing as well as the initial takeout financing in a single loan, with a 10-year term. Effectively, this could cover a 1-2 year construction/ rent-up phase so would require refinancing at around the 8th year of operation.
- Interest only payments during construction through to full rent-up and stabilization (roughly 12 months after occupancy); principal payments commence only after one year of full stabilized operations (this reduces costs in the initial operating year by the principal amount of amortizing loan).
- At the end of the 10-year term, the loan would be refinanced using CMHC loan insurance facilities at the then prevailing insured loan rates.
- The direct loan will be CMHC insured, but no premiums will be charged (a potential saving of up to 4% of the loan amount).
- The loan may be amortized over longer than normal terms, to a maximum of 50 years. This results in lower payments which, when reflected in the debt coverage ratio (DCR), increase the potential loan amount.
- Loans may cover up to 100% of cost, subject to viability – the normal loan-to-value (LTV) maximum 85% requirement is not applied. So the DCR at a minimum of 1.1 (compared to the normal minimum DCR of 1.2) becomes the primary limiting factor. This further improves leverage, **and most importantly lowers the developer equity required** – which enhances the resulting return on equity.

- In return for favourable loan features developers are required to include some social outcomes, including modest affordability criteria, inclusion of accessible design and energy efficient construction standards. It also rewards collaborative partnerships and transit oriented development. Overall these are not onerous criteria, but will affect the maximum loan (may fall to 90% of cost if minimum criteria not exceeded).

Lower interest rate effect

CMHC officials have advised that the construction loans will be priced relative to the benchmark Canada 10 year bond. In the past week this has ranged from 1.46-1.57%. CMHC suggest an indicative spread of 32-50 basis points over this benchmark, which implies a rate of 1.8 to 1.95%. It is noted that refinancing of renewals on existing social housing, also using the Crown Borrowing Facility, is currently priced somewhat lower at 1.35% on 5-year terms.

Private lenders suggest current CMHC insured loans with 25-year amortization and 5-year term would be around 2.25%. A 10- year term amortized over 40 years would be at 2.98%. Meanwhile BC Housing and Infrastructure Ontario are funding 10-year loans at 2.6%.

Against these comparable rates, the benefit of the rental construction loan appears to be in the order of 75-100 bps.

Key eligibility criteria

In order to qualify for this favourable financing, developers must propose viable projects meeting a range of affordability, energy and accessibility criteria. Key among these are:

Affordability

- Rental income must be set 10% or more below potential market income. So, for example, if average achievable market rent is $1,250 per month, the maximum must be $1,125 (averaged over project).
- A minimum 20% of the units must be at rents affordable at 30% of the median household income in the local market.

Energy efficiency

- Projects must achieve a minimum 15% decrease in energy use and greenhouse gas emissions relative to the 2015 model building codes (this will marginally impact capital costs but enhance operating costs for utilities and potential marketability of units).

Accessibility

- At least 10% of the project's units must meet or exceed accessibility standards for the municipality, and all common areas must be barrier-free (this is a higher proportion than most private developments would typically include).

Potential Recalibrating the affordability benchmark

The RCFI requires that 20% of units be provided at rents at or below an affordable benchmark. As designed this is set at 30% of median household income. A review of median income data suggests that this criteria may not achieve its intent – it results in rents that are in fact higher than all other rents, rather than lower.

There is also an issue with lack of timely data from which to calculate and annually update the benchmark. This issue and potential solutions to establish a benchmark consistent with the policy intent of greater affordability is discussed in Appendix C.

For the purpose of modeling the impacts of the RCFI here, a proxy measure of 100% of the average market rent (AMR) from the CMHC rental market survey is used.

In addition to meeting the minimum criteria, as noted above, CMHC has created a social outcome matrix, which awards points to proponents who exceed the minimum commitments. This covers the three key criteria above, as well as criteria related to collaborative partnerships and undertaking transit oriented development. Those proposals that only achieve the minimum requirement can qualify for a maximum loan-to-cost ratio of 90%. To increase the LTC (and thereby reduce equity required) a higher performance is required across the five social outcome criteria.

Social Outcome and Project Viability Assessment Tool

This tool is intended to help proponents look at various scenarios by providing some information regarding the proposed project such as costs, financing and sources of equity. The tool is designed to help determine if a project meets the mandatory minimum requirements for financial viability, affordability, energy efficiency, accessibility, partnerships and transit oriented development.

The scoring matric is attached as appendix D. This details the points awarded when proposed projects exceed the minimum eligibility criteria

- For example, under the 20% affordability requirement, greater depth of affordability is rewarded, with a addition point for each 10% by which proposed rents are below the median income affordability criteria (so if 30% of median is $1,000, this gains "0" points, rents at 10% lower, $900, would generate 1 point; 20% at $800 gets 2 points).

- For energy efficiency projects that are 15-25% more efficient than model building code would generate an extra 1 point; 25% to 50% more efficient gets 2 point… and a net zero energy project gains a max of 5 points.
- The “Fostered collaboration” criteria award points to projects involving partnerships. This could be beneficial where a private developer partners with a non-profit, who may provide ongoing management to facilitate extending the affordability period beyond the minimum 10 years and as such could help to create such partnerships. It also recognizes collaboration with municipalities that may offer some benefits such as waived fees and charges, or expedited approvals (although municipalities may also seek an extension or expansion of affordability outcomes).

This social outcomes matrix culminates in three rating tiers, based on the points earned by incrementally exceeding minimal criteria. These three tiers are then the basis for setting the maximum loan-cost ratio (assuming that the project is viable at a 1.1 DCR):

- Tier 1 (0-9 points) LTC up to 90%;
- Tier 2 (10-18 points) LTC up to 95%;
- Tier 3 (19-25 points LTC up to 100%.

Although a more detailed underwriting assessment will be required by CMHC when an application is formally submitted, the tool is claimed to offer sufficient information to explore different options prior to submitting a proposal. A test of the tool found that is lacks instruction on inputting and is not entirely intuitive. Expert Excel users will likely find their way through it, but it could be improved to be user-friendlier.

It is also unclear how the performance standards linked to the point ratings and thus maximum loan will be validated. This could leave the developer with a contingent liability to insert more equity if the resulting building and project fail to achieve proposed performance standards.

2. Modeling the Financial Viability of the RCFI

In order to fully explore how this new initiative may work, and how effective it might be in attracting investment and construction, an illustrative pro forma for a 1-2 bedroom apartment project has been developed. The pro forma is based on a previous analysis that developed typical pro formas for apartment projects in the Greater Toronto Area (GTA) and Halifax. [1]

The GTA pro forma is used here to highlight the impacts of the RCFI on the economics of a rental project. Comparable impacts based on the Halifax pro forma are highlighted later. The GTA pro forma used in this analysis broadly reflects the current cost to develop new rental projects in the GTA, including land, construction and soft costs as well as typical operating expenses. The details of the illustrative pro forma are presented in Appendix A.

The analysis commences with an examination of the costs, revenues and cash flow associated with the GTA rental apartment project using current loan financing parameters as applied by lenders for CMHC insured loans – as well as rent levels (140% AMR) that have been achieved in recently completed rental developments. This is referred to as the *base case*.

The parameters of the new RCFI, as outlined above were then modeled in comparison to the base case. These parameters are grouped here by *benefits*: lower loan rate, reduced DCR and longer amortization; and by *obligations* (the quid pro quo for obtaining the benefits): discounted rents relative to full market potential, inclusion of 20% of units at more modest affordable rents and requirements for energy efficiency and accessibility.

The impact of the RCFI requirement to set rents at a 10% discount of market potential was modeled by assuming full market rents at 140% AMR for the base case, and discounted rents set at 125% AMR for the RCFI pro forma. To reflect the additional requirement that rents in 20% of units be further lowered to 30% of median household income, a proxy affordable benchmark at 100% AMR was assumed.[2]

In order to better understand the impact of different elements of the RCFI, each element was sequentially examined, as well as aggregated to complete a total comparison. This included incrementally assessing:

Benefits:

- Reduction in the interest rate (here lowered by 80 basis points;
- Reduction in the minimum DCR from 1.2 to 1.1; and,

[1] See Pomeroy and Lampert, *Purpose-Built Rental Housing: Assessing Potential Federal Program Design Options,* prepared for CHBA, 2016.

[2] This differs from the way this requirement is currently specified. As discussed earlier, it is not clear that the current criteria will generate lower rents. So, for the purpose of modeling this objective a value at 100% AMR is used here.

- Extension of the amortization to 50 years (from 25).

The modeling for the RCFI pro forma includes the program detail that the existing loan balance is refinanced after 10 years (with the first two as construction and stabilization years, effectively this refinancing occurs at the end of the eighth operating year). It is assumed that the project is refinanced at the base case CMHC insured loan rate (here 2.6%) amortizing over the remaining 40 years. This effect is captured in the mortgage payments and cash flows in Years 10 and 15.

Obligations:

- Discount rents 10% (assumed to be 125% AMR vs. 140% AMR in base case);
- Further reduce rents in 20% of units to an affordable benchmark (here represented by rents at 100% AMR); and,
- Increased construction costs for energy efficiency and accessibility (based on input from developers experienced in LEED Platinum development the modeling estimates the additional cost at 7% for these two requirements).
- The achievement of performance beyond these minimum eligibility criteria (i.e. exceed percent or duration of affordability, accessible units etc.) was not modeled.

These incremental effects are consolidated in an overall assessment, which also adds an adjustment in rents to full market (140% AMR – indexed from current AMR) in Year 10 after the affordability requirements expire, though this would be subject to prevailing local/provincial rent regulation.

Assessing impacts of the RCFI

The effect of these incremental RCFI elements on the base case are examined here in terms of their impact on:

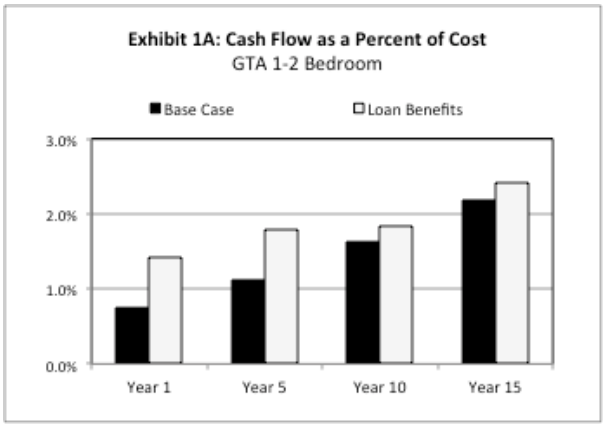
- The level of investor equity required;
- The cash flow generated initially and in successive years (here using years 1, 5 10 and 15) as a percentage of cost; and
- The investor's return on equity (RoE).

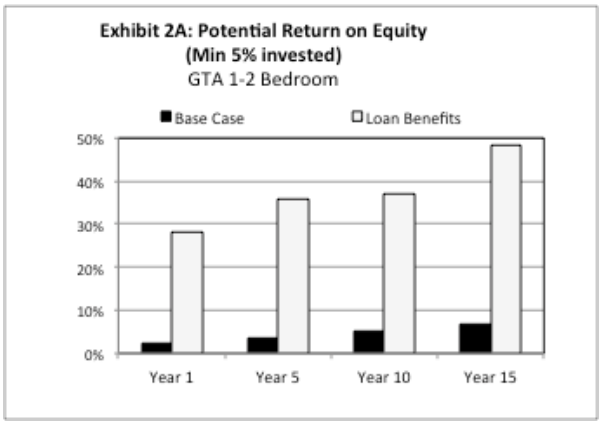
Measuring RoE becomes problematic when the loan is approved at 100% of cost (ensuring this is supported by the viability of revenues to cover loan payments – through the 1.1 DCR) because equity becomes zero and the calculated RoE is then infinite. To manage this arithmetic challenge, for illustrative purposes, we have arbitrarily established a notional equity level at 5% of cost, and calculate RoE against that amount (but without actually reducing the loan to 95%). This is simple a way to measure and illustrate the investor return.

And, with application fees and the need to exceed minimum eligibility criteria, it is likely that a max loan-to-cost of 90 to 95% is more likely, so the scenarios paint a more realistic picture.

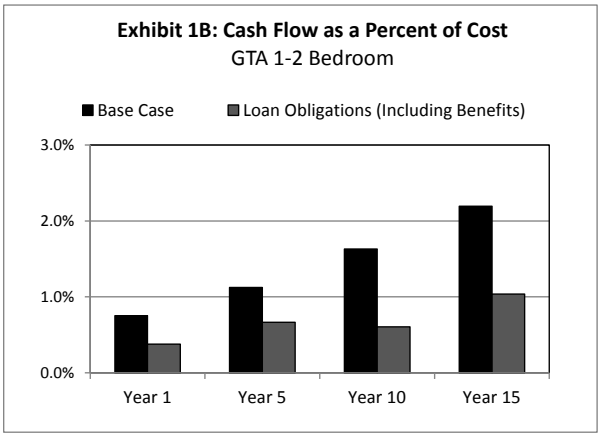
Incremental effects of the RCFI loan elements – GTA Project

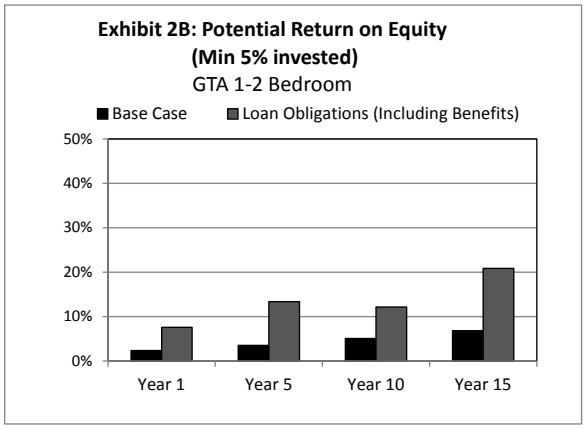
A. Impact of loan benefits



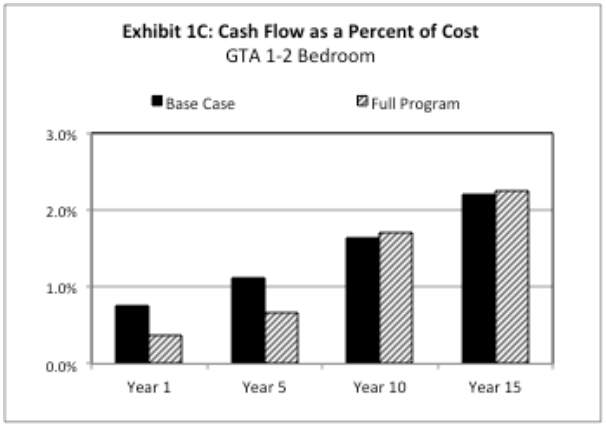


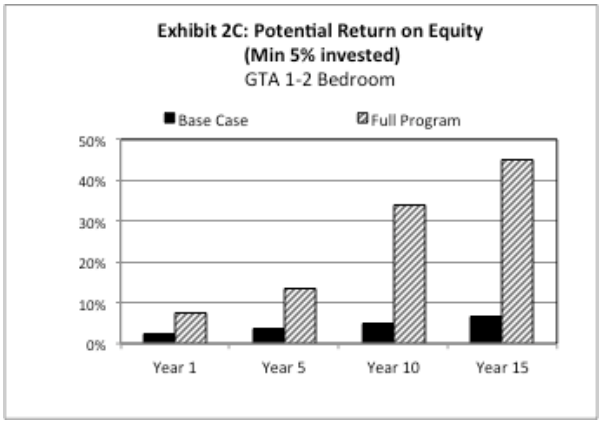
B. Net Impact with obligations





C. Overall Impact (benefits, obligations and future rent adjustment)





3. Findings from the Analysis

The Exhibits on the previous page incrementally identify the impact first of the three benefits of the RCFI, then the three obligations, and, finally, the overall impact in comparison to the base case – using the pro forma for the GTA apartment project. Note that these are cumulative so the obligations are net after benefits calculated. The chart pairs in the Exhibits show:

A – How these elements impact cash flow presented as a percentage of cost (a ratio typically used to measure yield on a rental property); and,
B – The return on equity (using the notional equity level of 5% for the project with RCFI funding for arithmetic purposes since the project qualifies for a 100% loan).

The first pair of exhibits illustrate the impact of the loan benefits. They show that the lending conditions are quite favourable compared to the base case. They generate higher yield (Ex 1A), especially in the early years, when the benefits of the low interest loan apply. (Mortgage payments increase in Year 9 due to refinancing of the RCFI with an insured loan – the initial direct loan was for 10 years starting at construction). The project also generates a substantially higher return on equity (Ex 2A) compared to the base case. However, this is before any of the obligations are applied to the project.

The second pair of exhibits adds in the effect of reduced rents (note these are cumulative on the previous benefit calculation). It also includes the energy and accessibility requirements that mainly add to cost. Because the project qualifies for a 100% loan, the additional cost is absorbed in a larger loan which increases the mortgage payment amount and somewhat reduces net cash flow. Nonetheless, the main effect of the obligations is due to the reduction in cash flow resulting from the lower rents.

Cash flows and yield as a percent of cost (Ex 1B) are lower than the base case. However, since the developer has not had to contribute equity, these are free cash flows. Using the proxy minimum of 5% notional equity, the return on equity investment (Ex 2B) is still very favourable, exceeding 10% within 5 years.

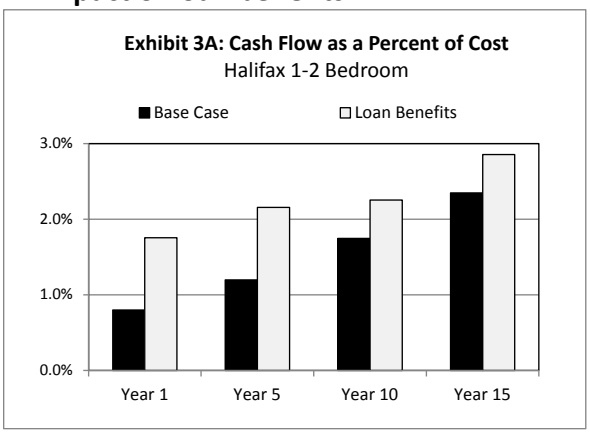
Finally, the third pair of exhibits adds in the effect of the potential to move rents to full market after 10 years. Ex 1C/2C show that overall; the RCFI generates slightly lower yield in the first five years (but free cash flow since there is no equity), and a slightly better yield in Year 10 and later. And the imputed return on equity (assuming the 5% equity proxy) exceeds 40% – a very healthy return.

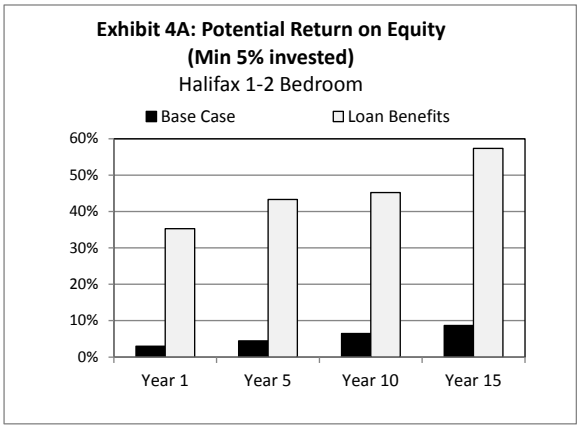
Additional findings for Halifax

The exhibits on the next page present the results of applying the RCFI to the Halifax apartment pro forma, and are detailed more fully in Appendix B. The findings are not significantly different from those presented above for the GTA project – in general, cash flows and RoE for the Halifax project appear to be even more favourable for the developer than those for the GTA project.

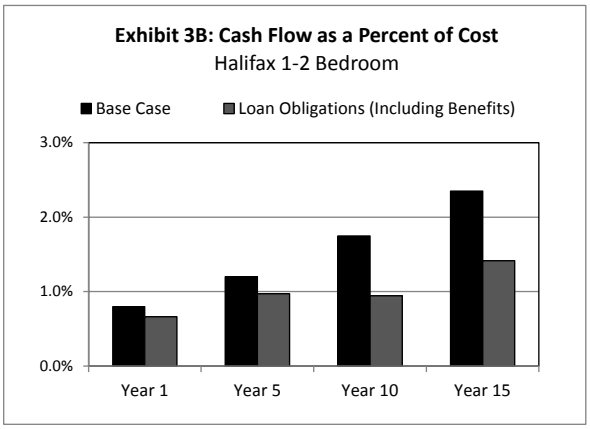
Incremental effects of the RCFI loan elements – Halifax Project

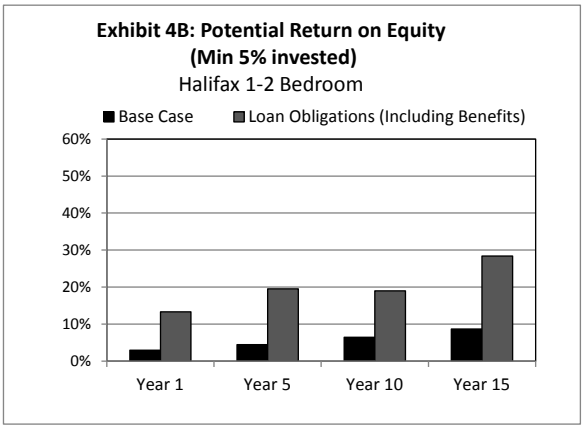
A. Impact of loan benefits



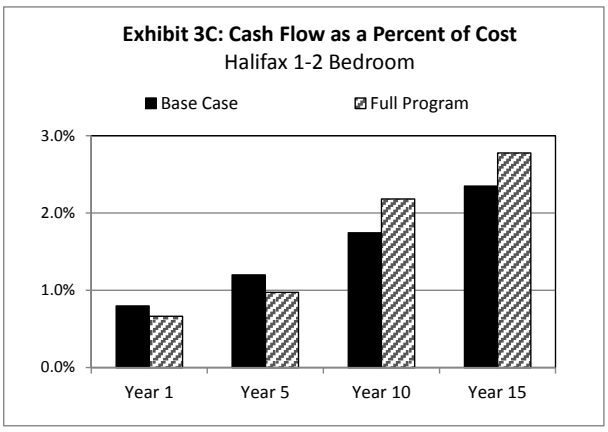


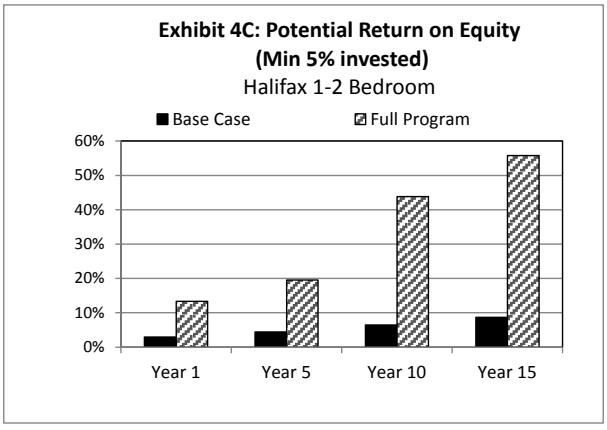
B. Net Impact with obligations





C. Overall Impact (benefits, obligations and future rent adjustment)





4. Other Considerations

This assessment (based initially on the Toronto pro forma and confirmed by the Halifax analysis) suggests that the RCFI could have a significant positive effect in attracting investment and in stimulating purpose built rental development.

For investor/developers the RCFI presents a choice:

- Proceed under existing private finance parameters and maximize rental returns; or
- Utilize this lending facility and accept a quid pro quo in the form of various social outcome criteria already noted.

The latter obligations entail slightly reduced revenues (discounted by 10% in 80% of units; and lower further to affordable levels in the other 20%) as well as some slightly higher costs to accommodate social objectives of reduced energy use (beneficial to tenants and could therefore strengthen marketability of units) and ensuring 10% of units are fully accessible (again potentially offset by demand from an aging population that may increasingly need and demand such features).

In addition, in order to achieve a loan at or very close to 100% of cost, it is necessary to exceed the minimum social outcome criteria, as discussed earlier. Some of these may generate a "win-win" outcome:

- Partnering with a non-profit may help to achieve deeper affordability outcomes and duration, and secure sufficient outcome points to reduce equity required.
- The criteria of reduced energy use would beneficial to tenants and could therefore strengthen marketability of units.
- Ensuring 10% of units are fully accessible (again potentially offset by demand from an aging population that may increasingly need and demand such features).
- And sites near transit locations can also benefit with social outcomes points, which may contribute to achieving a higher loan ratio.

Another consideration for proponents is the process of securing loan approvals. If the process is significantly more onerous than the unassisted private finance route, this will act as a deterrent. It is notable that favourable financing and especially attractive construction financing rates are offered for affordable housing developments in Ontario by Infrastructure Ontario and in British Columbia by BC Housing. In both jurisdictions (and especially in Ontario), despite more favourable rates many proponents have elected to seek private finance due primarily to what are seen as onerous and slow loan application processes. In part, this reflects a risk adverse public sector, a more bureaucratic process, as well as officials that often have less familiarity with loan administration compared to private lenders with more frequent experience and expertise in processing loans. Borrowers have traded off slightly more favourable rates for a less burdensome process.

The implication for CMHC officials that have not been in the business of loan administration for many years (except renewals of social housing direct loans) is that *process matters* and if perceived to be excessive, can discourage program take up (especially for regulation-adverse private proponents).

Leaving aside this processing consideration, the assessment found that by far the most beneficial feature of the RCFI is the potential to borrow up to 100% of cost with up to a 50-year amortization period. Combined, and individually, these are far more significant that the relatively small reduction (75-100 BPS) in the interest rate (since all rates are currently already very low).

These features substantially reduce (or eliminate) the developer equity required and thus significantly enhance return on equity.

As shown in the exhibits, while the base case (without the RCFI financing) generates a better cash flow (largely because the mortgage amount is smaller, because of investor equity), on the basis of return on equity, the RCFI generates very significant returns to the investor (and note that here these are understated by imposing a 5% equity amount to facilitate calculation).

The minimal or zero equity requirements may also be an important feature for more entrepreneurial non-profit providers. These organizations typically lack capital even though some may have potential leverage in existing assets once operating agreements expire. Many are seeking to become more financial sustainable, and one way to do this is to undertake market or mixed rent development, where surpluses from market units can help to build reserves or to cross subsidize their social purpose activities. As designed the RCFI may provide a valuable facility to pursue such development. Not for profit proponents may also be more likely to retain the sub-optimal rents after 10 years.

5. Concluding Observations

Overall, the analysis here concludes that the Rental Construction Financing initiative (RCFI) may be quite effective in attracting investment and stimulating construction of purpose built rental housing. The initiative seems likely to be attractive to both private developers and to non-profits. The minimal equity requirement may make it attractive to non-profit providers that lack equity but seek to improve the financial viability of their operations by adding market rates rental units.

There are, however, some implementation challenges.

Most notable among these is the affordability criteria to encourage a portion (20%) of units to have lower more affordable rents. A review of the rent levels that would result based on using the proposed 30% of local household income appears to generate higher rents than intended – often higher than the rents recently achieved in new private market rental developments.

Appendix C discusses the issues relating to limited data sources and the need to better calibrate the criteria with the policy objective.

The requirement to establish rents with a 10% discount to market may help to generate new construction in the intermediate market, however there is no mechanism to target these units to moderate income tenants who would benefit most.

In a general supply program that seeks to attract and encourage developers, it is desirable not to impose onerous obligations, however, some restrictions seem appropriate in this case. Without any targeting or eligibility criteria, the discounted rents may simply remove revenues from developers without directing the benefit to more moderate income renters that would most benefit from the public finance initiative.

Similarly for the 20% of units required to be at more affordable levels, some administrative mechanism is necessary to target these. One option would be to require developers to enter into a rent supplement contract for a minimum of ten years. The basis of the contract would pay the owner a rent established at the benchmark (e.g. the 30% median or recalibrated rent level) with a local housing agency or provincial department administering a rent supplement program – referring tenants, and where necessary adding rental assistance to help lower income tenants.

Appendices

- Appendix A: Description of the Base Case Pro forma Used in This Assessment
- Appendix B: Results of Halifax pro forma
- Appendix C: Assessing Affordability Criteria
- Appendix D: CMHC Social Outcome Criteria and Reward Matrix

Appendix A: Description of the Base Case Pro forma Used in This Assessment

The analysis in the main body of the report is based on pro formas for rental developments, which were adjusted from a set of pro formas developed by the same consultants in a report prepared for the CHBA in 2016. The pro formas in that report were created to reflect current development and operating costs for modest rental housing projects in both the GTA and Halifax. These represent both a higher-cost and moderate-cost rental housing market.

The pro formas for the 2016 report were considered to be representative of modest rental developments (in terms of amenities, size and location) – and have market rents equivalent to 120% AMR. This was consistent with the perception (at that time) that a program to encourage new rental development would be targeted at the intermediate part of the rental market – with market rents below those that would generally apply for most new market rental developments, which typically have rents in the 130-140% AMR range. The pro formas confirmed the general perception that rental housing developments targeted at the modest part of the market were not an attractive investment.

The recently announced Rental Construction Financing initiative does not specifically target the intermediate rental market (although the 10% rent discount seeks to push in that direction). To model the impact of the new initiative on the most economically attractive part of the rental market, the pro formas in the 2016 report were adjusted to account for the higher costs which would be associated with rental developments targeted at the higher end of the market (140% AMR). To achieve this, the costs were adjusted upwards by 10% to provide a more realistic reflection of the broad costs associated with a higher-end product than the modest projects examined in the 2016 report. And rents were set at 140% (in the base case) to be consistent with the cost estimates.

The pro formas are based on information provided by industry representatives and are considered to be reasonably reflective and illustrative of true costs. However, they should be treated as relatively rough estimates. They are considered to be sufficiently reflective of costs to illustrate how different measures increase the viability and the attractiveness of development – the primary purpose here. The focus is on the *relative* impact of each measure on investment returns from the potential development, rather than *absolute* values.

The Exhibit on the next page presents a simplified pro forma for a 100-unit project with a mix of 1-2 bedroom apartments in the GTA: A market-rent project reflecting 2016 costs and assuming a market rent of 140% AMR.

For ease of understanding, all values are presented on a per unit basis.

The summary pro forma for the GTA 1-2 bedroom apartment base case (adjusted from the 2016 report) is presented in Exhibit A-1. Key features include:

- Land costs and construction costs have been adjusted upwards by 10% from the 2016 report.
- Soft costs exclude DCC's, which are separately identified and tend to be quite high in the GTA, even for apartment units.
- HST is calculated at the net effective rate reflecting both the federal and Ontario rebates applied to the estimated fair market value of the project – based on NOI (discussed below) and a 4.5% cap rate (not project cost).

Exhibit A-1: **Base Case Illustrative Pro Forma Rental Apartment** ($ per unit)
GTA 1-2 bedroom

	Base Case	
Development Costs and Financing		
Land	49,824	
Construction	199,294	
Development Charges	40,000	
Total Cost	289,118	
HST	15,563	
Project Costs	304,680	
Financing		
Equity	98,204	
Mortgage Financing	206,476	
Mortgage Insurance Premium	4,130	
Total Mortgage	210,606	
Revenues, Costs and Cash Flow	Base case	
	Year 1*	***Year 5***
Revenues	20,508	22,642
Total Operating Costs	7,040	7,773
NOI	13,468	14,869
Mortgage Payments	11,448	11,448
Cash Flow	2,290	3,422
Return on Equity (cash on cash)	2.3%	3.5%

** Year 1 is first year of stabilized operations*

Financing is a function of the rental income and expenses (NOI) and an assumed 4.5% cap rate. [3] The base case assumes a CMHC insured loan with the loan amount calculated at the lesser of the 85% loan-to-value (LTV) ratio or 1.2 debt coverage ratio (DCR).

- An insured loan requires a mortgage insurance premium, which is added to the mortgage loan and paid off over time. It is assumed that the mortgage has a rate of 2.6% amortized over 25 years.
- Revenues are mainly rental income (less a vacancy allowance). In this Exhibit, rents are assumed to be at 140% AMR (which a rational developer would set for new development). The lending value for the project (based on NOI and the cap rate) is a reflection of these market rents. There is also a small allowance for other revenues from parking etc. Both rents and other revenues are inflated at 2% annually.
- Operating expenses are based on typical operating costs such as management, maintenance, and utilities in common areas, insurance and advertising. These are inflated at 2% annually.
- Property taxes reflect the multi-residential rate applied against an estimate of fair market value (again, calculated using a 4.5% cap rate and NOI). These are also inflated at 2% annually.
- Net operating income (NOI) is a key element in the pro forma, as it directly impacts capacity to borrow and thus both the loan amount and residual required investor equity (cost less maximum financing).

Developing the new financing pro forma

The base case pro forma from Exhibit A-1 has been adjusted further to capture the elements of the new rental construction finance initiative (RCFI) – and provided in Exhibit A-2. The key adjustments are:

- The mortgage rate is reduced from 2.6% to 1.8% to reflect the indicative rate suggested by CMHC officials (a spread of 35-50 basis points over Canada 10 year Bonds).
- Soft costs are reduced for interest during construction to reflect the lower loan rate.
- The DCR is reduced from 1.2 to 1.1, amortization extended to 50 years and the LTV constraint is removed, allowing a loan up to cost (subject to the DCR calculation accommodating this).
- The CMHC insurance premium is waived.

[3] Discussions with industry confirm that cap rates are a central element of their financial viability assessment. Cap rates are based on the 2Q 2016 CBRE update. A midpoint in the survey range for low-rise apartments has been used in each of Toronto (4.5%) and Halifax (5%).

- Rents are reduced from 140% AMR to 125% AMR to reflect the requirement to discount the rents to 10% below market potential, and in addition rent in 20% of the units is reduced to 100% AMR (a proxy for "affordable criteria" which appears to require some recalibration – see Appendix C).
- Although not shown in Exhibit A-2 rents are adjusted upward after Year 10 when the affordability requirement expires. All units increased to 140% AMR indexed at 2% since year 1.

Exhibit A-2: **Illustrative Pro Forma Rental Apartment Comparing Impact of New Financing Against Base Case** ($ per unit)

GTA 1-2 bedroom

	Base Case	RCFI Financing
Development Costs and Financing		
Land	49,824	49,824
Construction	199,294	209,457
Development Charges	40,000	40,000
Total Cost	289,118	299,280
HST	15,563	12,313
Project Costs	304,680	311,594
Financing		
Equity	98,204	0
Mortgage Financing	206,476	311,594
Mortgage Insurance Premium	4,130	0
Total Mortgage	210,606	311,594

Revenues, Costs and Cash Flow	Base case		New Financing	
	Year 1*	***Year 5***	***Year 1****	***Year 5***
Revenues	20,508	22,642	17,696	19,538
Total Operating Costs	7,040	7,773	7,040	7,773
NOI	13,468	14,869	10,656	11,765
Mortgage Payments	11,448	11,448	9,686	9,686
Cash Flow	2,290	3,422	970	2,079
Return on Equity (cash on cash)**	2.3%	3.5%	7.6%	13.3%

** Year 1 is first year of stabilized operations*

*** RoE (new financing) calculated on minimum 5% equity for illustrative purpose*

Exhibit A-2 shows a small increase in construction cost. This combines a small reduction in soft

costs due to lower interest costs during construction at the lower loan rate, and increased costs to reflect higher energy standards and constructing 10% of units as fully accessible.

Together these are estimated to add 5-7% to cost (based on developers experience in the LEED Platinum development).

With reduced rents, the assessed fair market value is reduced, which lowers the HST payable.

The most significant change is the reduction in the required investor equity. The loan program offers financing up to 100% of costs, provided that the NOI supports the larger loan (at a 1.1 DCR), and in this case it is sufficient to do so.

No mortgage insurance premium is charged on the loan.

Rent revenues are lower, reflecting the criteria for rent discount and affordability, and this results in a reduced NOI. While the loan is larger, the longer amortization and lower interest rate reduce the mortgage payments substantially.

With reduced rental income and much lower NOI, the cash flow (after debt costs) is significantly lower ($970 yr 1) than that in the base case ($2,290 in yr 1).

With 100% loan to cost, there is no investor equity. To develop an estimate of return, a notional amount of 5% of cost is used. This generates a substantially higher rate of return on equity (13.3% by Year 5) compared to the base case (3.5%).

Caution is in order in interpreting these results. Because the base pro forma has been relatively crudely adjusted from the pro forma used in the 2016 report, interpretation of the results should focus on the *relative difference* between the base case and the effect of the RCFI financing, not the actual numbers themselves.

Based on the pro forma here, it appears that the RCFI enables developers to build with minimal or no equity, and generate reasonable cash flows, which in part due to no equity, represent valuable returns. After 10 years, there is an opportunity to gradually raise rents to full market potential, subject to prevailing rent regulation, which will further enhance returns. In combination this is likely to be attractive to private investor-developers.

Appendix B: Halifax pro forma

Parallel to the GTA pro forma in Appendix A, a similar typical pro forma was developed in the earlier 2016 work to create an illustrative development in Halifax.

The Halifax market provides a useful separate test as a lower cost centre. Halifax is also somewhat unique as there is only a minimal volume of new condominium development, with most multi unit development directed to the rental market. In part this is because home prices are much lower so they are accessible to first time buyers. As a result, land values are not as heavily influenced by competing condominium development (which in larger higher cost cities pull up multi residential land values).

Exhibit B-1: **Base Case Illustrative Pro Forma**
Rental Apartment ($ per unit)
Halifax 1-2 Bedroom

	Base Case	
Development Costs and Financing		
Land	31,706	
Construction	154,000	
Development Charges	2,863	
Total Cost	188,569	
HST	27,085	
Project Costs	215,654	
Financing		
Equity	58,365	
Mortgage Financing	157,289	
Mortgage Insurance Premium	3,539	
Total Mortgage	160,828	
Revenues, Costs and Cash Flow	Base case	
	Year 1*	***Year 5***
Revenues	16,309	18,007
Total Operating Costs	6,050	6,680
NOI	10,259	11,327
Mortgage Payments	8,742	8,742
Cash Flow	1,723	2,585
Return on Equity (cash on cash)	3.0%	4.4%

** Year 1 is first year of stabilized operations*

As shown in Exhibit B-1, the base case pro forma, all cost components (land, hard costs, soft costs and especially development charges) are much lower than in the GTA pro forma. On the other hand, HST is considerably higher since there is no rebate of HST for housing in Nova Scotia. The result is that the total cost of the base case (similar blend of 1-2 bed units) is considerably lower (215,654) than in the GTA ($304,680).

While rents are also lower in Halifax than in the GTA, the difference is proportionately less. Costs are 70% of those in the GTA pro forma, but rents are 80% of those in the GTA. This generates a stronger pro forma in which investor equity is lower ($58,400) and yield and return on equity is slightly better.

Exhibit B-2: **Illustrative Pro Forma Rental Apartment Comparing Impact of New Financing Against Base Case** ($ per unit)

Halifax 1-2 Bedroom

	Base Case	New Financing
Development Costs and Financing		
Land	31,706	31,706
Construction	154,000	161,687
Development Charges	2,863	2,863
Total Cost	188,569	196,256
HST	27,085	21,245
Project Costs	215,654	217,501
Financing		
Equity	58,365	0
Mortgage Financing	157,289	217,501
Mortgage Insurance Premium	3,539	0
Total Mortgage	160,828	217,501

Revenues, Costs and Cash Flow	Base case		New Financing	
	Year 1*	***Year 5***	***Year 1****	***Year 5***
Revenues	16,309	18,007	14,097	15,565
Total Operating Costs	6,050	6,680	6,050	6,680
NOI	10,259	11,327	8,047	8,885
Mortgage Payments	8,742	8,742	6,761	6,761
Cash Flow	1,723	2,585	1,286	2,124
Return on Equity (cash on cash)**	3.0%	4.4%	13.3%	19.5%

** Year 1 is first year of stabilized operations*

*** RoE (new financing) calculated on minimum 5% equity for illustrative purpose*

Exhibit B-2 shows the new financing in comparison to the base case for the Halifax pro forma. As in the GTA, the NOI at a 1.1 DCR is sufficient to support a loan at 100% of cost and this eliminates any developer equity requirement. While net cash flow (after debt) is lower as a result of lower rents and a larger mortgage, the return on equity is far superior, and will be attractive to developers.

Appendix C: Assessing Affordability Criteria

The financing initiative includes a requirement that 20% of units have rents at or below 30% of median income. This is intended to ensure one-fifth of units are at lower more affordable rents. As currently stated, it is apparent that the benchmarking at 30% of median income is ineffective in achieving lower more affordable rents. If CMHC wishes this outcome to result it will be necessary to revise the criteria. In the US, area median income is used but there it is benchmarked at 60% of area median income (then multiplied by 30%).

The reason that this is inappropriate is twofold:

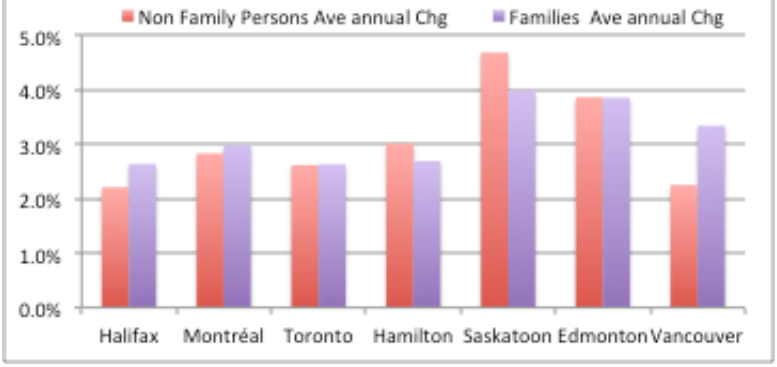
- First while linking affordability to a household income benchmark may be desirable, in practice it is challenging to implement because of the lack of annually published data on median household income.
- Second, median incomes are too high to result in affordable rent levels.

Median household income is available from the National household Survey 2011, and will be available later this year from the 2016 Census). Both measure household incomes from the prior year (so 2010 and 2015 respectively). There is no inter-censal update at the household scale with geographic coverage of all CMA's and CA's. Statistics Canada does publish median income data based on tax filer information, but this too is somewhat out of date – the current data is available only up to 2014, and 2015 data will not be available until late this year. In addition, this data series does not provide data at the household level – it provides incomes for individual tax fliers, families and persons not in a census family.[4] Even with custom tabulations Statistics Canada is not able to generate household data.

With these data limitations, options would be to index historic incomes (e.g. from each census file) or to develop a proxy.

Indexation is also a challenge because incomes do not necessarily inflate at similar rates across different households and different cities, as shown in Exhibit C-1. Some locally-based wage index will be necessary, but

Exhibit C-1: Average Annual Change in Median Income 2010-2014



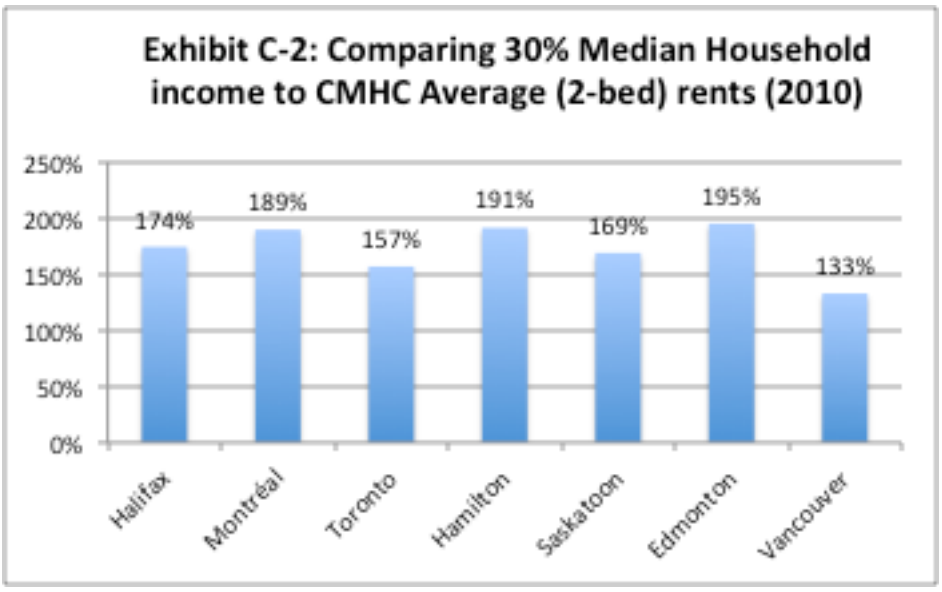
[4] Families are comprised of: 1) couples (married or common-law, including same-sex couples) living in the same dwelling with or without children, and 2) single parents (male or female) living with one or more children. Persons who are not matched to a family become persons not in census families. They may be living alone, with a family to whom they are related, with a family to whom they are unrelated or with other persons not in census families. Beginning in 2001, same-sex couples reporting as couples are counted as couple families.

this requires computation, so data is not readily available or transparent.

An alternative is to use a proxy. While it would be desirable to use an income measure to reflect affordability, it may be more practical to draw on a source that is widely available (and used) and updated annually – the CMHC rent survey. Previous analysis has found that the CMHC average rent roughly approximates the value determined by using the 30% affordability criteria against 60% of the area median income. In addition, 100% AMR is already in use as the upper boundary of affordability under the Investment in Affordable Housing framework.

As noted above using 30% of median generates rents well above the average, and in most cases above the rent level that is required across the loans in this program (must be 10% below full potential market). Recent new rental construction is creating units that are rented at between 135-145% of the average market rent (AMR). So a 10% discount will be roughly equivalent to 125% AMR.

However based on the planned criteria, the one-fifth of units intended to be affordable based on 30% of median income will actually exceed the overall rents in the project (assumed to approximate 125% AMR. As shown in Exhibit C-2, the so-called "affordable rents" derived by comparing 30% of median income to the AMR for 2-bedroom units in 2010 were between 133% and 191% of the AMR in major centres across Canada.



Similarly, Table C-3 presents tax filer data for the same 2010 base year data for non-census persons (individuals) and families, and compares 30% of these incomes against AMRs for bachelor (singles) and 3 bed (family) units. This too shows that with the exception of singles in Toronto and Vancouver, resulting affordable rents are well above 100% AMR.

Clearly this was not the intent of the policy or criteria. With the affordable benchmark already well established in the IAH programming at 100% AMR, it seems that would be a more logical

basis to benchmark this requirement. It also has the advantage that the rent data is collected and updated annually. The CMHC rent survey is well established, timely and transparent.

Table C-3 Median Income data - selected CMAs 2010

A. Cansim data series for families and persons not in census families *				CMHC 2010 Rent Survey		30% criteria as % AMR
	Family type	Cansim 2010	30% median	Bach	Three+	
Halifax	Persons not in census families	26,950	674	632		107%
Montréal	Persons not in census families	23,000	575	526		109%
Toronto	Persons not in census families	23,230	581	777		75%
Hamilton	Persons not in census families	26,230	656	529		124%
Saskatoon	Persons not in census families	29,450	736	599		123%
Edmonton	Persons not in census families	32,980	825	708		116%
Vancouver	Persons not in census families	24,660	617	811		76%
Halifax	All families	76,500	1,913		1146	167%
Montréal	All families	67,010	1,675		860	195%
Toronto	All families	68,110	1,703		1322	129%
Hamilton	All families	76,730	1,918		1095	175%
Saskatoon	All families	80,570	2,014		959	210%
Edmonton	All families	87,930	2,198		1171	188%
Vancouver	All families	67,090	1,677			

** Source: Statistics Canada Cansim Table 111-0009 Family characteristics, summary Annual Income Estimates for Census Families and Individuals (T1 Family File) - 4105*

NHS 2010 all households **

Selected City (CMA)	Median Household Income	30% Median	Two-bed AMR	30% criteria as % AMR
Halifax	62,067	1,552	891	174%
Montréal	53,012	1,325	700	189%
Toronto	70,360	1,759	1123	157%
Hamilton	65,842	1,646	862	191%
Saskatoon	63,029	1,576	934	169%
Edmonton	79,096	1,977	1015	195%

Vancouver	63,397	1,585	1195	133%
*** Source: NHS 2011 Custom table 99-014-X2011031*				

Appendix D: CMHC Viability Tool – Social Outcome Eligibility Criteria and point system

SUMMARY

Project DCR		0.00	90% PGI	Yes
Project LTC		0%	20% of Units at Median HHI	No
Total Loan		0	90% of HHI	No
			80% of HHI	No
Eligibility Criteria	No		70% of HHI	No
Social Outcome Score	Up to 90% LTC			

Affordability - duration	10 Years (Eligibility Requirement)	0			
	More than 10 years and up to 15 years	1			
	More than 15 years and up to 20 years	2			0
	More than 20 years	3			
Affordability – depth of affordability (in the rent amount)	Rents at 100% of median income (Eligibility Requirement)	0			
	Rents at 90% of median income	1			
	Rents at 80% of median income	2			0
	Rents at 70% of median income or below	3			
Affordability – number of units	20% of total units (Eligibility Requirement)	0			
	Up to 5 more units over the eligibility requirement	1			
	From 6 more units to 10 more unit over the eligibility requirement	2			0
	More than 10 units over the eligibility requirement	3			
Accessibility	Project contains adaptable units, in addition to minimum 10% of unit accessible requirement.	2	0= No 1= Yes		0
	Project contains units with universal design, in addition to minimum 10% of unit accessible requirement.	2	0= No 1= Yes		0
Energy Efficiency	15% more efficient than 2015 model building codes (Eligibility Requirement)	0			
	More than 15% and up to 25% more efficient than 2015 model building codes	1			
	More than 25% and up to 50% more efficient than 2015 model building codes	2			0
	More than 50% more efficient than 2015 model building codes	3			
	Net zero energy ready or equivalent standards of performance	5			
Fostered Collaboration					
Partnerships	Are other Non-profit or For-profit Developers, Urban Aboriginal Groups, or Municipalities, involved in this project	0 = none 1 = 1 partner or more			0
Other Government Supports: (Federal/Provincial/Territorial/Municipal)	• Grants • Concessions on property taxes • Concessions on levies • Waiver of development cost charges or other provincial/municipal fees • Expedited Approvals • Waiver of community amenity contributions • Other	0 = no support 1 = 1 or 2 supports 2 = 3 or more supports			0
Land donation		2	0= No 1= Yes		0
Transit Oriented	Within 1 km of public transit such as bus stop, train station, rapid transit or subway station	1	0= No 1= Yes		0
	Project offers access to alternative forms of public transit (parking spots for car sharing service, shuttle bus service, direct connection to underground path system, etc.)	1	0= No 1= Yes		
Your Score					**0**
Potential Loan To Cost Percentage					Up to 90% LTC

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Tiers	Min	Max
Up to 90% LTC	0	9
Up to 95% LTC	10	18
Up to 100% LTC	19	25