Canadian Residential Real Estate

Home Alone 5, But Without the Home

The housing market in Canada saw world-leading pricing spikes in the run-up to the COVID-19 pandemic. Then, due to lockdowns and remote work, Canadians were forced to relocate to far-flung locations in search of more space. This prompted prices to rise exponentially in places that had previously been immune to the fast rise in housing prices in Canada's major cities. However, as life resumes normalcy and the Bank of Canada tightens monetary policy to bring down excessive inflation, the Canadian housing market is beginning to slump. This report will go over the key constituents in the industry such as past and present demand, past and present supply, headwinds from the tightening of the monetary policy, price components and fees, as well as short-term and long-term outlook of the sector.

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Products & Services Segmentation

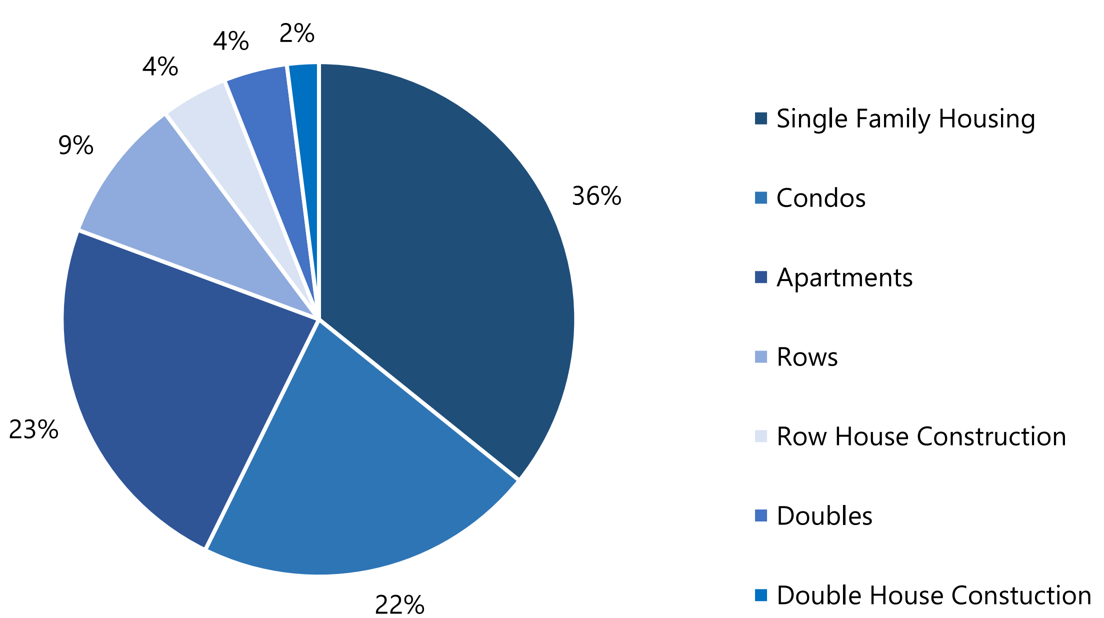
The value chain in the Residential Real Estate industry can be broken down into 3 key parts: construction, sales and brokerage, and the homeowner. The first section of this report will be focused on the first 2 steps of the value chain.

Construction. To segment the construction component, it must first be broken out into two main buckets of construction: homebuilders and apartments/condos. The former can then be segmented into single-unit house, double house, and row house construction. Homebuilders construct homes that are separated by walls and have no units above or below them. The latter consists of construction of high-rise apartments, townhouses, condominiums and medium-to-high-density units. Another way to separate the two is classifying homebuilders as single-family unit construction, and apartment/condos as multifamily unit construction. Together, the value of this market is $78.1B. The majority of the market is consumed by single-unit housing, condos, and apartments, taking up 81% of the residential construction market.

The apartment segment in particular is experiencing growing demand as individuals seek more affordable living arrangements. Moreover, Canadians are shifting to multifamily options as a whole because of the growing urban population, increasing single-family home prices, and retiring baby boomers looking to downsize.

The residential sales and brokerage component comprises brokerage firms and independent representatives aiding in the sale or purchase of homes, condos, and apartments. It’s valued at $15.1B and can be more logically broken down by geography. Ontario, BC, Quebec, and Alberta alone account for 93.8% of the market, with the rest split among the remaining provinces. Competition in the sales and brokerage space is local and has been escalating due to increased marketing expenditure

Figure 1: Residential Construction



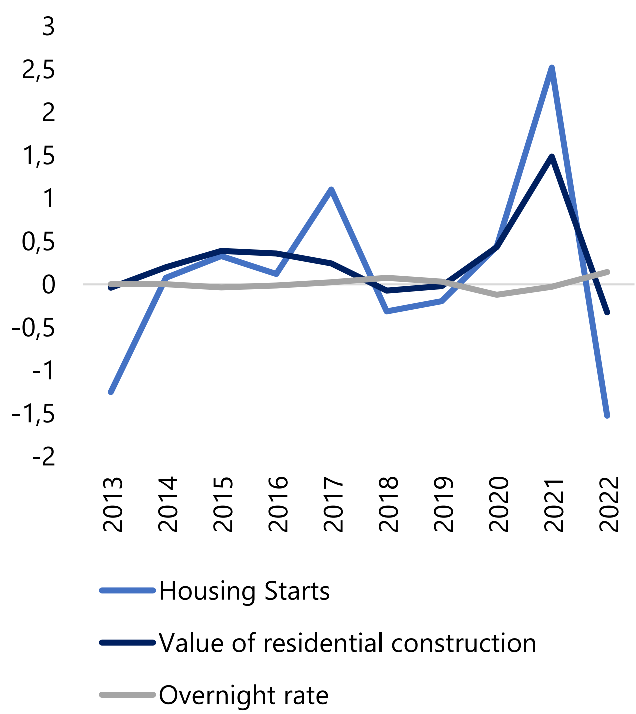
Source(s): IBIS World, Mordor Intelligence

Industry Overview

Determinants of Industry Performance

The Canadian Residential Estate industry is tied closely to traditional economic factors; namely, interest rates, population growth, disposable income levels, employment levels, etc., and suggests the industry is highly cyclical. Arguably one of the most important variables is interest rates, which is inversely related to the performance of both construction and the sales and brokerage markets. In the chart below, when the overnight rate moves upwards, the value of residential construction and housing starts to trend downwards. The higher interest rates lead to more expensive project funding and lower investment, which then limits housing starts and lowers real estate values. It's important to note these relationships, because the value of residential construction will drive brokerage revenue, and housing starts are going to drive home builder revenue.

Figure 2: % Change in Overnight Rate vs Value of Residential Construction and Housing Starts



Key Players

Mattamy Group Corporation is Canada's largest Homebuilder with 2.8 % market share and is projected to generate $920.7M in industry relevant revenue in 2021.

RE/MAX has been the number one real estate organization in Canada, and continually has the highest market share in every region. They specializes in residential real estate transactions, operating a franchise network comprising more than 4,600 offices located in 44 countries.

Bridgemarq Real Estate Services Inc. is the largest provider of marketing, promotional, networking partnership and professional development service provider in Canada with 18,000 Real Estate Professionals. The company has grown through strategic acquisitions, and the largest franchise it owns is Royal LePage.

Source(s): IBIS World, Mordor Intelligence

Industry Overview

Key Regions

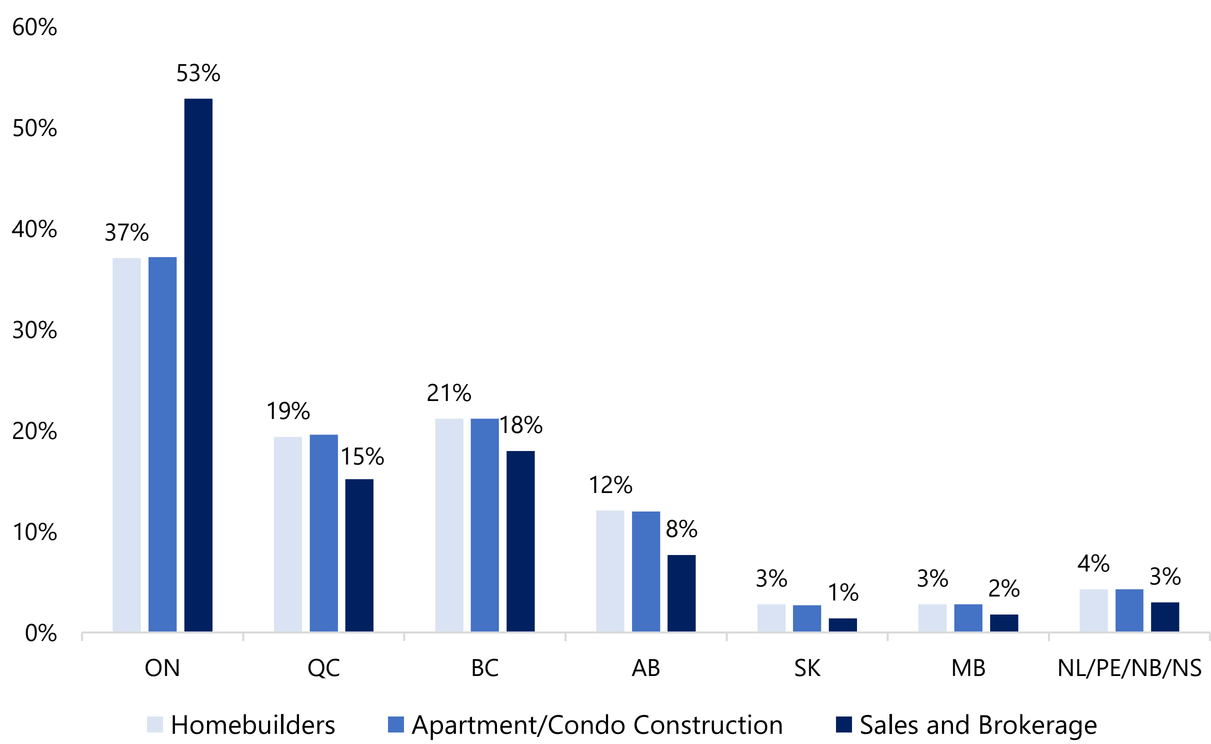
The most important regions for residential real estate follow population distribution. Therefore, the principal areas are going to be Ontario, Quebec, BC, and Alberta. Establishments find themselves predominately in densely populated areas with major cities being Toronto, Ottawa, Montreal, Vancouver, Edmonton, and Calgary. The major cities are important to note, as Residential Real Estate competition is highly localized, both in construction and selling, due to the nature of the business. Especially in sales and brokerage, where it’s very client centric and customer facing, and having strong local and regional presence can be an advantage for brokerages.

Ontario continues to be a leading center for real estate activity as it is the country's most wealthy and populous province. However, the northern part of the province relies heavily on commodity-oriented industries, implying more cyclicality and slowed demand in times of economic hardship.

Out west in BC, Vancouver is deemed the top market to watch for the third year in a row due to abundance of capital and increased immigration activity. Another activity fueling Vancouver's housing market is intergenerational wealth transfers where homeowners are passing on large sums of wealth onto children who in turn are looking to purchase a home. However, these non-market transactions can hurt the sales and brokerage business as the middleman is often cut out in these related party transactions.

In Alberta; more specifically, Calgary, the market is more optimistic than the recent past due to increased oil prices, improved employment levels, and immigration activity. Calgary has also seen faster population growth than the rest of the country, which will likely lead to a surge in housing demand and a higher volume of transactions.

Figure 3: % of Establishments by Region



Source(s): IBIS World, Mordor Intelligence

Industry Overview

Revenue Drivers: Value of Residential Construction

As mentioned before, the value of residential real estate is an important driver of revenue for multiple different parts of the market; namely homebuilders, apartment and condo construction companies, and sales and brokerage firms. Recently, the level of residential investment has declined due to rising interest rates and high inflation figures, which has decreased the value of residential construction. This is following a sharp rise in 2021 because of low interest rates to help support the economy during the COVID-19 pandemic. A lower value of residential construction, lowers construction company and brokerage revenue as there is lower investment in residential real estate, lower transaction volumes, and lower commissions paid to brokerages. The value of residential construction was $172B in 2021 and is expected to decline the next 2 years as the market cools down and rates rise, before picking up again in 2024.

Figure 4: % Change in Value vs Sales

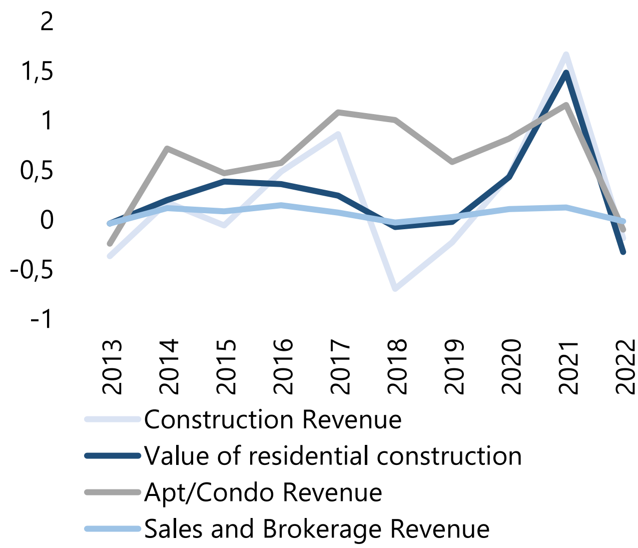
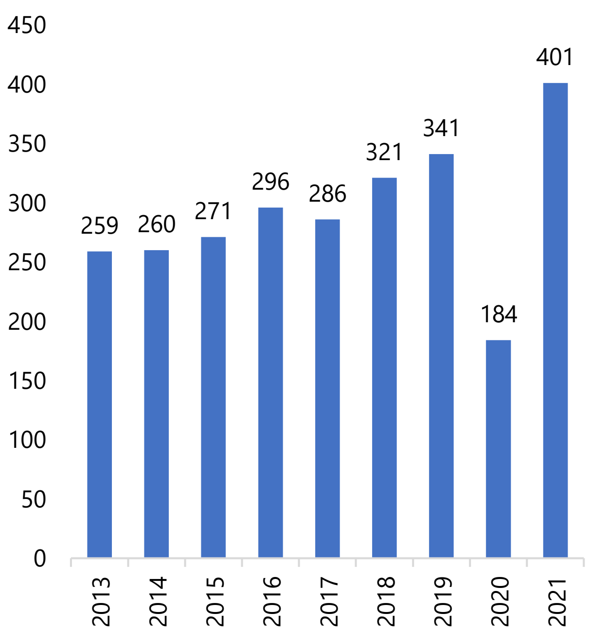


Figure 5: New Permanent Residents (000s)



Revenue Drivers: Immigration & Demographics

Both housing starts and the value of residential construction drive industry performance, and what underpins those levers are traditional economic variables. However, a few key factors, immigration and demographics, have yet to be noted. Demographics define the age, income, and preferences of potential buyers. In 2021, Canada's millennial population was roughly 10.5 million, and these individuals need family suitable homes which will drive the demand for home buying, and therefore housing starts and the value of residential construction. Homeownership rates within this age group often grow dramatically, which could have a long-term impact on housing starts. Second is immigration, as aged Canadians and baby boomers retire, luring immigrants to fill gaps in the workforce becomes increasingly important. Canada focuses on highly skilled immigrants, who are more likely to have higher incomes and can purchase coveted housing. Canada set a goal for 411,00 immigrants by 2022, so the inflow is likely to continue.

Industry Overview

Cost Drivers: Materials Costs

A major portion of the cost structure of residential construction is the cost of materials; namely, lumber, concrete, and steel. As a percentage of revenue, material costs can be between 40-60% depending on the current prices for these products. As commodities, they are largely impacted by the general economy. Higher demand leads to increased prices and therefore can significantly pressure construction profit margins.

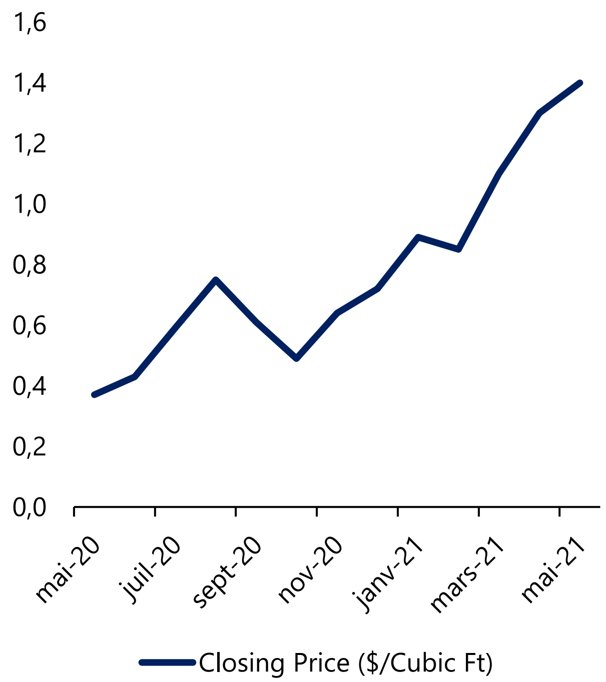
Lumber is the main material used in homebuilding and residential construction projects. Lumber prices have been quite volatile since the beginning of the COVID-19 pandemic, being as high as $1,670 per thousand board feet in May 2021, and as low as $475 per thousand board feet in August 2021. Prices started the year at roughly $1,200 per thousand board feet and are currently just over $500 per thousand board feet at the end of July - more than a 50% drop off despite aggressive recent inflation. This is likely driven by a drop in spending on homebuilding and construction due to the high prices at the beginning of the year, and rising interest rates to slow inflation, therefore limiting investment in construction projects. These factors are causing inventories to build and encouraging sawmills to slash prices.

Concrete is another main material used in residential construction because of its many advantages. Its durable, can shield homes from mold, moisture, fire, and it retains heat well. The average cost of a concrete slab (6" thick) is between $5.00-5.50 per square foot.

Homeowners pay between $2,247-3,040 on concrete for about 240 square feet. This cost will vary depending on local prices, the type of concrete and finish desired, thickness, and multiple other factors.

Steel prices have also dropped off considerably since the start of 2022, down 24% on the year. This is due to the fact that there are worries over a Chinese recession, and they happen to be the worlds largest producer of crude steel. Current steel prices are around $770 CAD per tonne, and it's a major component in residential construction projects.

Figure 6: Lumber Prices (000s)



Cost Drivers: Labour Costs

Labour is a major cost driver for both construction and sales and brokerage. For construction, a lot of the labour costs are associated with subcontractors hired to complete specialized jobs throughout the different phases of construction. For example, concreting, structural steel erectors, plumbers, electricians, etc.

Aside from construction subcontractors, construction firms also need to pay the costs of hiring architects, engineers, and designers. For brokerages, the wage component takes about 10% of revenue. The costs for an agent include base salaries plus commissions; however, most employees are paid based on 100% commission. Many agents actually work as contractors within a brokerage and pay a fraction of their commission as a royalty to the office they work out of. These commissions are roughly 5-6% of transaction value.

Source(s): Home Guide, Fortune Builders, Yahoo Finance, MacroTrends, Top Concrete, Trading Economics

Demand Trends

Rate Hikes

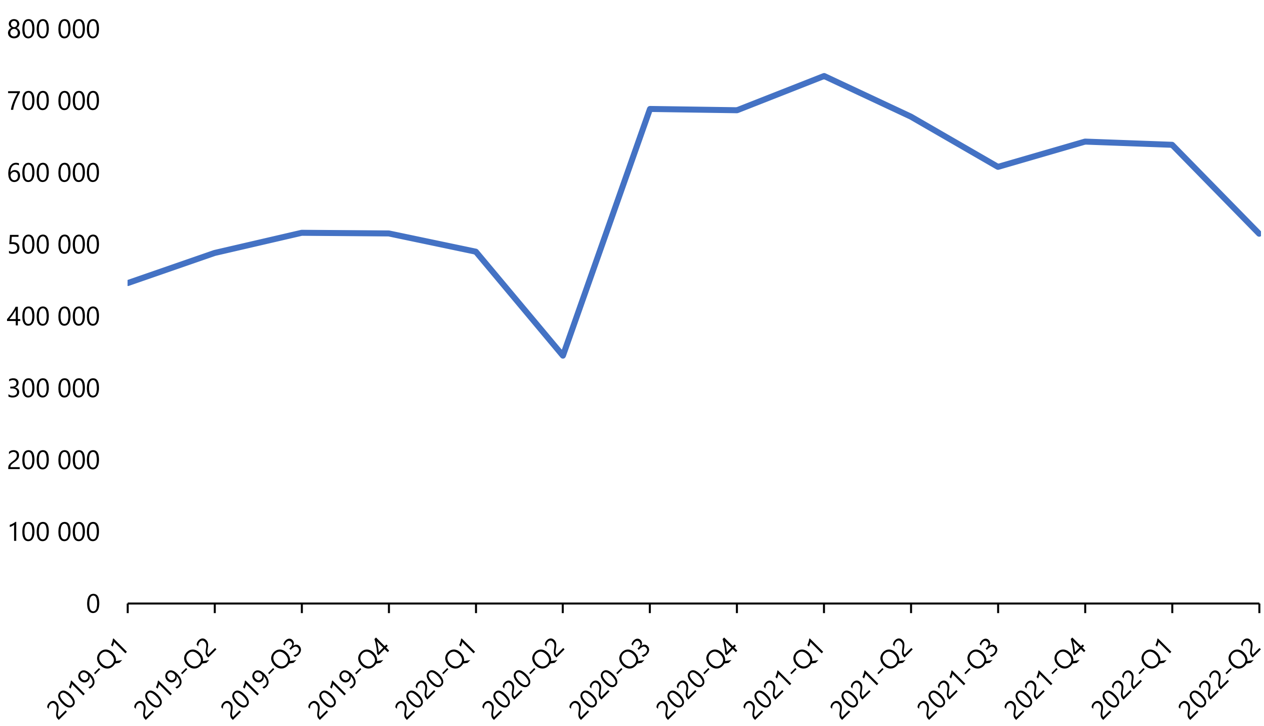
Interest rates were initially lowered to promote economic growth during the COVID-19 pandemic but have since been increased in recent months to combat inflation. This will be a significant catalyst for demand in both the short and long term of this industry as interest rates are a critical factor affecting all parties from construction companies to homeowners.

In efforts to control inflation, the Bank of Canada has implemented multiple rate hikes in the past months and is predicted to continue these rate hikes for the remainder of the year. Currently, the prime rate is sitting at 4.70%, up 100 bps from the previous rate of 3.70% and the Bank of Canada overnight rate is at 2.50%, previously at 1.50%. The rising rates have led to an increased cost of borrowing that has further discouraged potential buyers from purchasing a house in a market already facing difficulties with housing affordability.

The effects of rate hikes can already be seen in April when national home sales had a 12.6% MoM drop caused by the back-to-back interest rate hikes prior. Although the majority of buyers will hold onto their money, there may be a few who have pre-approved mortgages locked in at a lower rate that will choose to buy now as they expect even higher rates in the future. The 100 basis-point rate increase has also resulted in variable mortgage rates becoming approximately on par with fixed rates, effectively shutting down the last potential opportunity of super cheap borrowing costs available to buyers.

Overall, the current and potential future increases in interest rates will apply downward pressure on demand for the housing market as the cost of borrowing continues to increase.

Figure 7: Residential Sale Activity in Canada



Source(s): Home Guide, Fortune Builders, Yahoo Finance, MacroTrends, Top Concrete, Trading Economics

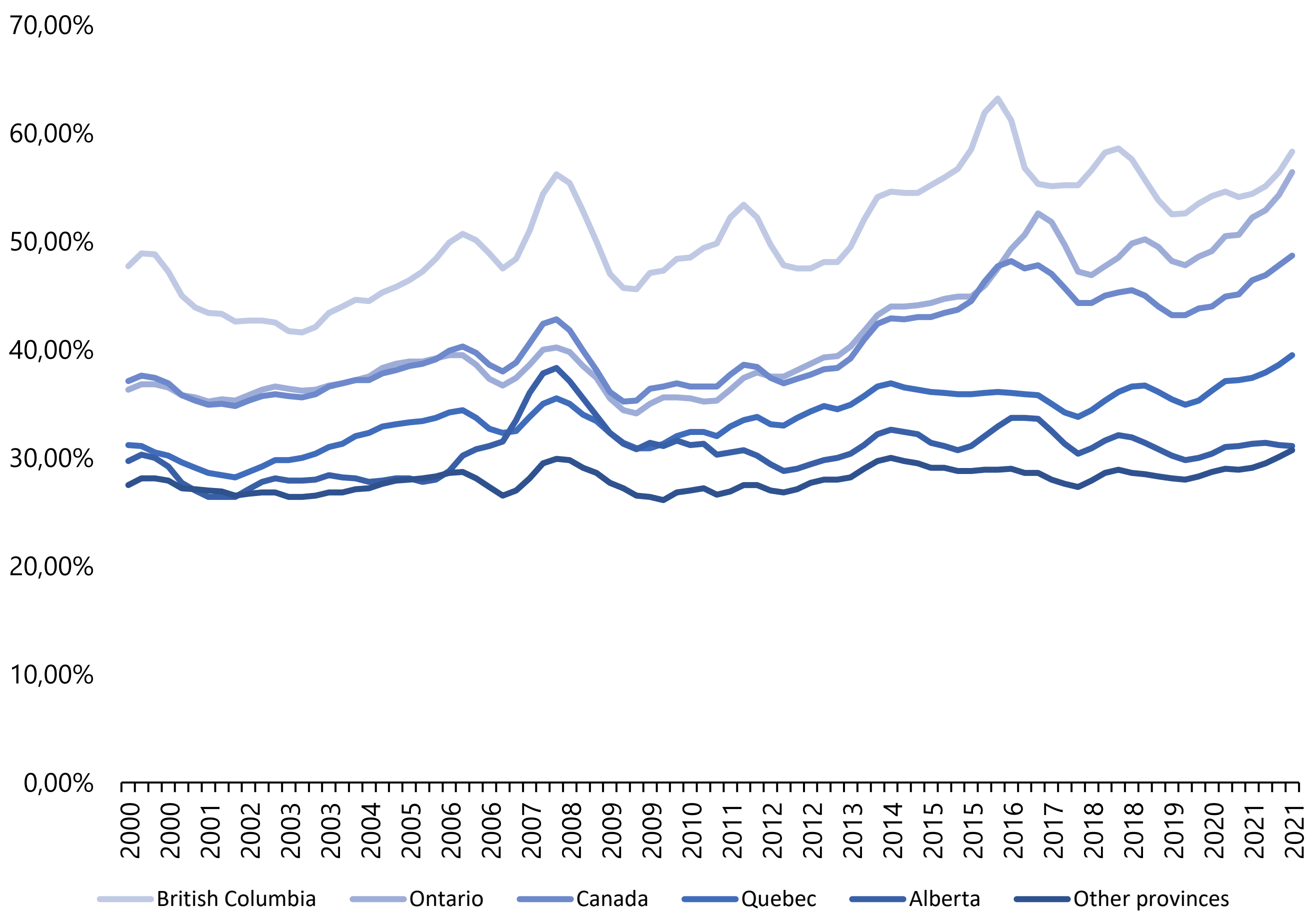
Demand Trends

Effects of Declining Demand

As mentioned previously, the current housing market has been getting increasingly unaffordable as prices have continued to rise due to the shortage in the supply and increase in demand in the prior years. With the rising interest rates, we should see a decline in demand as buyers focus on dealing with the rising interest rates and poor affordability of the market. This decline in demand will have a larger impact on already expensive markets, mainly Ontario and British Columbia, where the increased borrowing costs will have a larger impact. In markets such as Atlantic Canada and the Prairies we can expect some resilience due to their initial pricing being relatively affordable to begin with, but still expect slight decreases in demand.

The demand reduction will help cool down the current seller-dominated market and make housing more affordable in the long-term as sellers adjust pricing to meet buyers' budgets. Furthermore, this should allow for the previously low housing supply to build up inventory and help reduce future housing prices. This will also likely lead to increased demand in the long term as disposable income continues to increase over time and housing becomes more affordable compared to the current market. As the market returns to a more balanced state where supply constraints are no longer an issue, and demand can be met, we can expect that disposable income to be spent.

Figure 8: Housing Cost as a % of Disposable Income



Source(s): Home Guide, Fortune Builders, Yahoo Finance, MacroTrends, Top Concrete, Trading Economics

Supply Trends

Overview

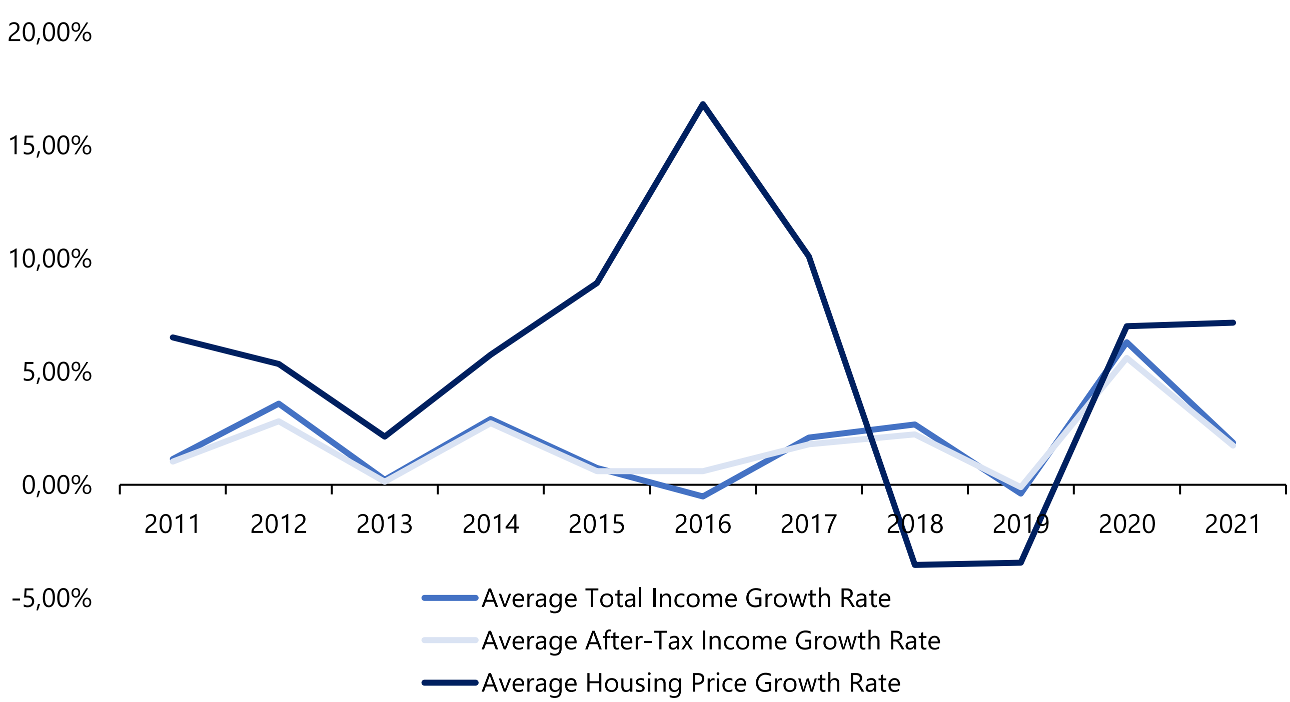
The supply for residential real estate in Canada has not kept up pace with demand for quite some time, resulting in some of the fastest-growing real estate prices in the world. The main challenges preventing significant increases in supply are the length of time that it takes to plan and begin construction of new properties, as well as the significant time required to seek and obtain government approval for development projects. Additionally, the situation is being further exacerbated by drivers of demand such as increasing Canadian annual household income, widening the disparity between the number of desired and available units.

The Canadian Mortgage and Housing Commission (CMHC) has projected a deficit of over 3 million housing units in Canada by 2030, a gap that must be filled in order to allow prices to return to an affordable level: approximately 30-40% lower than the current median national price.

Home Affordability

A main concern within major Canadian cities is the availability of affordable housing, typically defined as consuming less than 40% of a household's annual income. Affordability in this context considers two factors: income levels and the cost of housing. Housing price growth has outpaced the growth of median household income, with an average annual increase of 7.16% for single-family detached homes from 2010-2021, compared to a 1.85% average annual increase for total median household income in the same period. The changes in housing prices have been much more volatile than the changes to median household income which creates challenges for affordable housing prices, especially in 2016, where the national average housing price increased by nearly 16.8%, while median household income actually decreased by 0.52%. With home prices rising more than 30% in some markets in 2022, affordability has become even more of an issue, especially for prospective first-time homeowners.

Figure 9: Annual Income Growth vs. Home Price Growth



Source(s): CMHC, BusinessInsider, PwC

Supply Trends

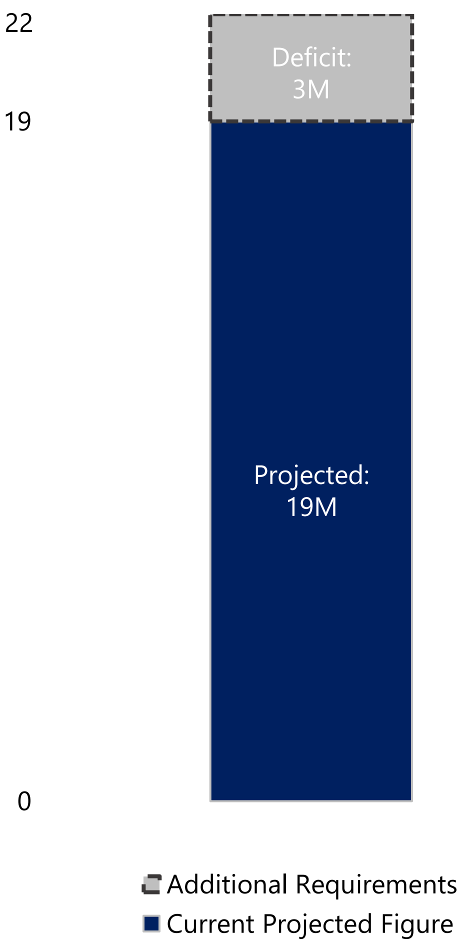
New Home Construction

In metropolitan areas such as Toronto and Vancouver, the average household is spending around 60% of their income on housing. This level of unaffordability can be attributed to a housing deficit of more than 3 million units, with two-thirds of this deficit contributed by the Ontario and B.C. markets. On the current trajectory, the stock of housing in Canada is projected to approach 19 million units by 2030, but in the Canadian Mortgage and Housing Commission's models, their central (base) scenario projects a figure of 22 million units needed, to begin to address affordability in Canada.

Availability of Labour

The number of construction workers per unit under construction is at its lowest point in 20 years. The historical average for the number of workers per project in Ontario and Quebec in the past 20 years was 6.6 and 10.2, respectively. In 2021, these numbers were at all-time lows, with 3.8 workers per project in Ontario, and 4.5 workers per project in Quebec - a stark decline from the historical average. This figure comes as a result of tremendous pressure within the construction industry as a result of material cost inflation, supply-chain issues, and disruptions from the pandemic.

Figure 10: Projections to Achieve Affordability



Number of New Projects

With high land costs, these various issues also create the risk of significant costs for new construction, which hurts the attractiveness of development projects. In 2021, the number of new dwelling starts in Canada, or the beginning of construction work at the location of a planned building, was 271,198. In Q1 2022, the annualized projection of dwelling starts was at just 237,412, a 12.46% decrease from the previous year. As of Q2 2022, this figure has increased to an annualized figure of 270,451, a number that has steadily increased throughout the year. However, to close the deficit of more than 3 million housing units required for affordable housing in Canada, the rate needs to be considerably higher.

Figure 11: Workers Per Unit Under Construction

Province	Historical Average (1996-2021)	All-time low	2021
Ontario	6.6	3.8	3.8
Quebec	10.2	4.5	4.5
British Columbia	6.1	3.3	3.3

Supply Trends

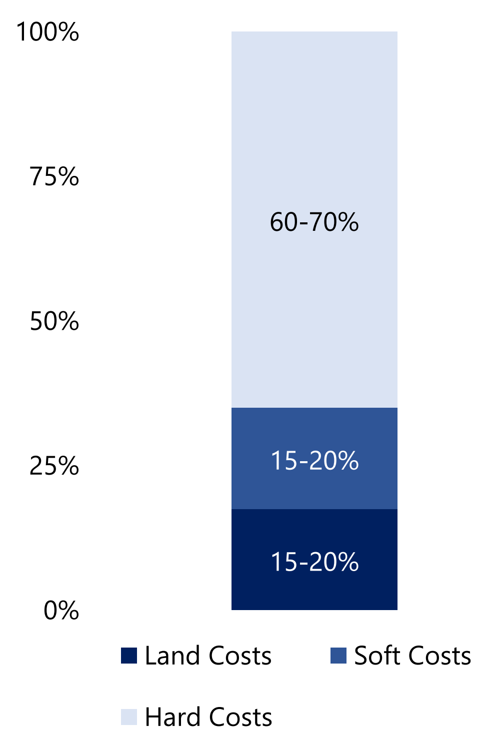
Rising Project Development Costs

A determinant of new housing projects are its associated development costs paid for with financing. Operating expenses are made up of financing costs combined with property management costs, and as development costs rise, this causes the operating expenses to rise in turn. Operating expenses must be covered by revenue, and the difference between them must be greater than zero, in order for the project to be viable. Typically, the breakdown of development costs involve the cost of land (15-20% of costs), soft costs such as design and permit costs (15-20% of costs), and hard costs such as labour and materials (60-70% of costs).

Factors Affecting Development Costs

The three buckets of development costs are heavily influenced by market forces and the government. Hard costs have been most heavily affected as both labour and material costs have increased by more than 50% due to heavy demand since 2000, which translates into higher rents for homeowners. Additional factors that impact both development costs and operating costs include tax hikes, project additions, and delays, which all result in financing or revenue gaps that drive higher rent and house prices for tenants and homeowners. A decrease in rent revenue brings major risk to projects as if operating expenses are no longer covered, leaving the project to no longer be deemed viable.

Figure 12: New Project Cost Breakdown



Cost of Materials

In Q1 2022, there was an acceleration of growth in costs of residential building construction, seeing increases of 6.8% in Toronto and Edmonton, as well as a 6.9% increase in Calgary. Rising construction costs can be attributed to a rebound in softwood lumber prices, with February future contracts peaking in 2022 at around $1,464 per thousand board feet. Steel prices were also elevated in February 2022 at $878 per ton but has since dropped by over 32% as of June 2022 to $590 per ton. Lumber prices have also seen recent relief, dropping by 63.1% to around $500 per 1,000 cubic board feet at the end of July 2022. Residential construction costs are still 22.6% YoY compared to 2021, and the high costs have added further headwinds to a difficult situation.

Source(s): CMHC, BusinessInsider, PwC

Valuation

Comparable Companies Analysis

Comparable Company Analysis
Residential Real Estate Industry

	Market Data			Valuation				Operating Statistics		
	Ticker	Market Cap	EV	P/E	EV/EBITDA	EV/EBIT	P/BV	Debt/EBITDA	EBDITA Margin	Revenue CAGR (5YR)
Company Name	TSX/NYSE	($M)	($M)	TTM x	TTM x	TTM x	TTM x	TTM x	TTM %	TTM %
FirstService Corporation	TSX:FSV	$5,817	$6,709	46.2x	18.7x	18.5x	6.9x	2.2x	9%	17%
Morguard Corporation	TSX:MRC	$982	$6,066	1.9x	6.8x	7.1x	0.3x	13.7x	41%	2%
Melcor Developments Ltd.	TSX:MRD	$320	$904	5.6x	9.7x	9.4x	0.4x	5.5x	37%	5%
RE/MAX Holdings, Inc.	NYSE:RMAX	$496	$435	-	3.8x	3.4x	1.0x	3.9x	28%	14%
Bridgemarq Real Estate Services Inc.	TSX:BRE	$96	$144	10.3x	6.6x	7.4x	-	2.2x	56%	3%
Mean				14.1x	10.4x	11.3x	1.8x	5.3x	30%	8%
Median				5.9x	8.1x	11.6x	0.6x	4.3x	33%	6%

Commentary

The Canadian Residential Real Estate Sector tends to have a skewed valuation. This is attributed to the fact that this industry has a lot of different revenue segments with differing margins such as construction, marketing, franchising, and many others. This leads to all the major players incorporating a unique mix of revenue streams in their business models.

Our comps set is comprised mostly of Canadian companies, but we also added RE/MAX (NYSE:RMAX) to our set considering their massive footprint in the Canadian space.

In terms of valuation, RE/MAX Holdings Inc. (NYSE:RMAX) seems to be the most attractive investment. RMAX trades at an EBITDA multiple of 3.8x compared to the industry average of 11.3x. Low debt levels (3.9x), solid margins (28%), as well as robust revenue growth (14% 5YR CAGR) are attractive considering a low EBITDA multiple. Although it might look concerning, RMAX's lack of a trailing P/E can be attributed to a recent one time write off of $50M.

The least attractive investment is probably First Service Corp. (TSX:FSV). FSV trades at a P/E of 48.6x and an EBITDA multiple of 18.7x. The market is likely valuing FSV at this level due to their very low debt levels (2.2x) and by baking in large amounts of growth over the past 5 years (17% CAGR). However, a relatively low EBITDA margin of 9% does not justify this valuation in our opinion.

Another peer we would avoid from an investment perspective is Morguard Corp. (TSX:MRC). Their obscenely high debt levels (13.7x) seem concerning and although a low P/E might look attractive, the valuation is very misrepresentative due to the large spread between their equity and enterprise value.

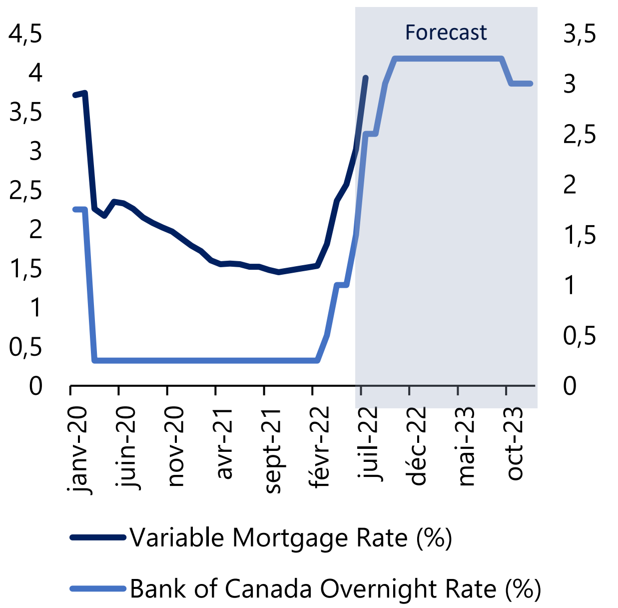
Source(s): Capital IQ, Yahoo Finance

Short-Term Outlook

Underlying Factors: Interest Rates

Inflation is touching four-decade highs and is only slated to climb even higher soon, and the Bank of Canada has taken an aggressive approach to address this. The Bank of Canada announced a 100 basis-point rate increase on July 13, 2022, which will undoubtedly speed up the cooling phase in the near term. This is a difficult pill for borrowers to swallow and will undoubtedly ruin or delay plans to be homeowners for many buyers. This interest rate hike brought variable mortgage rates about up to par with fixed rates, and as such closed the last window of heavily discounted borrowing costs available to buyers.

Figure 13: Variable Mortgage Rates vs Bank Rates



Underlying Factors: Affordability

The aforementioned rising rates are causing housing affordability to be on track to reach worst-ever levels. The more expensive markets like Vancouver and Toronto will be leading the way, but things will get more challenging across the country. However, they will be affected to a lesser degree because of their already favourable affordability starting points, and weaker sensitivities to interest rate changes.

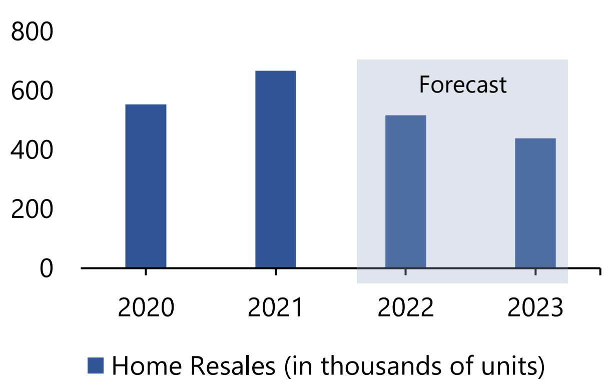
Growth Outlook

The CMHC expects growth in prices, sales levels, and housing to cool down from recent highs, but remain elevated in 2022. Key factors include robust GDP growth, higher employment and net migration, as they will support demand in light of pandemic subsidies. Price growth is expected to be led by the aforementioned "expensive" markets with low listing numbers, including Vancouver, Toronto and Montreal.

This outlook is subject to a variety of risks:

- Slower growth in housing supply in combination with a continued increase in household disposable income leading to further price growth
- Inflationary pressures and interest rate increases, leading to weaker starts and sales levels, and a slower price growth
- Lingering effects of the COVID-19 pandemic, such as restrictions, leading to weakened demand and price growth

Figure 14: Home Resales in Canada



Correction, Not Collapse

RBC Economics believes both activity and prices are set for a material correction. They do not rule out a more severe or prolonged slump, but expect the correction to begin in the first half of 2023 and last around a year. Solid demographic indicators and a low likelihood of overbuilding will keep the market from a "death spiral".

Source(s): RBC Economics, Bank of Canada, Canada Mortgage and Housing Corporation, CREA

Long-Term Outlook

Underlying Factors: Demand

While GDP and employment growth are expected to decline from 2021 to 2022, we expect growth to remain relatively strong. Furthermore, net international migration is predicted to increase in 2022. As a result, economic conditions are expected to sustain high levels of housing starts and home sales in 2022. Price increases are predicted to persist as a byproduct of higher demand and fewer listings.

Underlying Factors: Supply

Supply constraints on construction will continue to have an impact on the major cities of Vancouver and Toronto. This emphasizes the critical role of housing supply in determining affordability, particularly in cities like Toronto, where supply responsiveness has typically been low.

Underlying Factors: Immigration

Canada has continued to accept approximately 7.44% more immigrants every year since 2015. This rate is accepted to rise going forward till 2040. The desire for new immigrants to own homes rather than rent will contribute to excess demand. According to Statistics Canada, immigrants own more expensive single detached homes than Canadian-born residents, which, along with the pandemic's lifestyle shift, will drive up the price of these properties even more.

Figure 15: Number of Years Till Immigrants are Homeowners

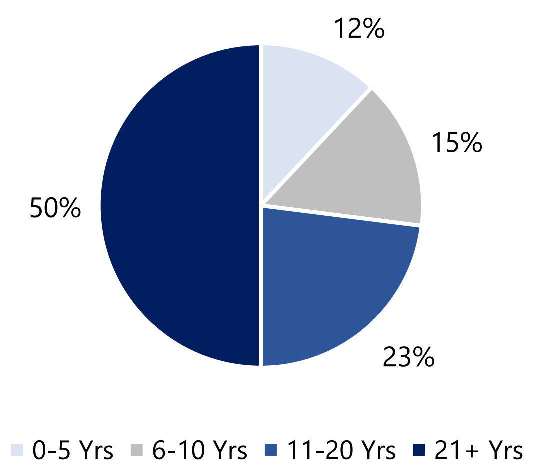
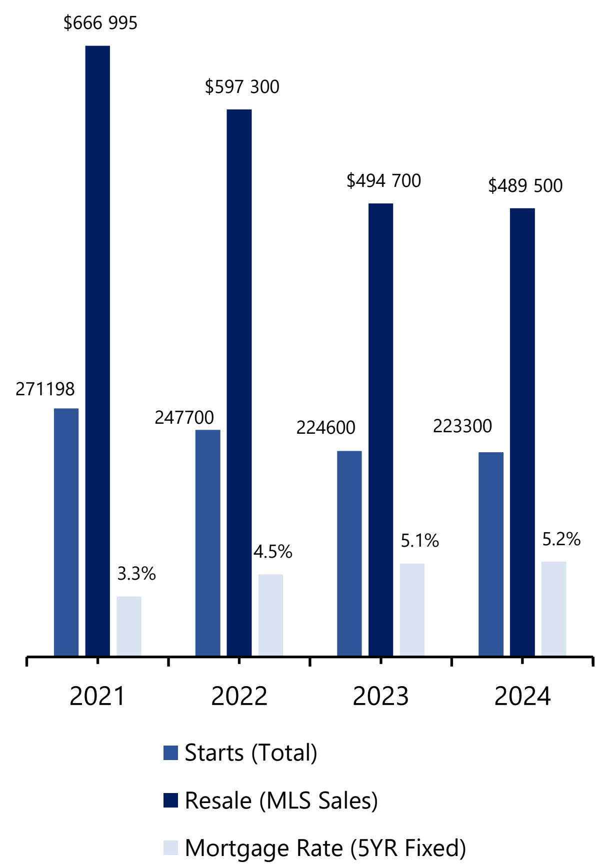


Figure 16: Starts, Resales, Mortgage Rate Forecasts



Outlook

In our best-case scenario, home prices would rise while interest rates remain at current levels. Compared to the previous year, home prices would grow 10.9% in April 2023. And at a 9.5% CAGR for the four years following 2023. While these figures may appear insignificant, over the course of five years, home prices would have risen by 61.7%. That's comparable to the growth over the previous five years; the distribution is merely different.

Our worst-case scenario (the more likely of the two) depicts a large contraction akin to the nineties and a lengthy correction. Prices for a standard home may fall by 30% over 12 months by mid to late 2023. The following four years will demonstrate a CAGR of 4.2% on average. Prices would be 15.8% lower over the five years ending in mid to late 2027.

Source(s): RBC Economics, Bank of Canada, Canada Mortgage and Housing Corporation, CREA