LOW RISE IS LOW RISK

Monday October 21, 2013 | By Ben Myers

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I have had the pleasure of speaking to several current investors and prospective investors in the Fortress Real Capital product, and I often get asked about the potential risks of investing in real estate and the specific deals we are offering. I often tell them that low rise is low risk, I instinctively knew this, but had never actually pulled the data to confirm my conclusion, so I did just that for this blog post.

According to the Canadian Mortgage and Housing Corporation (CMHC), 189,703 single-detached homes were completed in the Toronto Census Metropolitan Area (CMA) between 2000 and 2012. According to RealNet Canada Inc, 1,564 single-detached units were pulled from the market (discontinued by that developer at that time or "closed" per the RealNet definition) during that period. So, 189,703 units of the total 191,267 units available were built, for a success rate of 99.2%. Developers in Toronto should pat themselves on the back, that is quite an achievement. How confident would you be in winning a baseball game if your pitcher had a career record of 124-1?

Over the same time period listed above, just 445 semi-detached homes were pulled from the market and 44,647 completed, so 99.0% of the 45,092 units available were completed. For townhouses, 1,357 units were pulled from the market and 47,805 completed, so 97.2% of the 49,162 units available were built. For condominium apartments (high-rise), the success rate is lower at 88.4% with 19,445 units in cancelled projects, in comparison to the 148,548 units of completed condos between 2000 and 2012.

What are the typical reasons that a low-rise house would be "closed" or pulled from the market? There are many explanations, but the most frequent would be these three:

1. Wrong price. Let's face it, some developers misprice the market for a plethora of reasons – they paid too much for their land, got greedy, or were victims of a local, country-wide or global crisis that alters what they can charge for their homes. What many developers do is take the project from the market, rebrand it, re-price it, and launch it at a later date.

2. Wrong product. The best thing about low rise is it has such great flexibility – a developer can change the floorplans very easily, they can go back to the municipality and change the lot frontages, lot depths or change the homes from semi-detached to townhouses or vice-versa. The best thing a developer can do is react very quickly to shifts in market demand.

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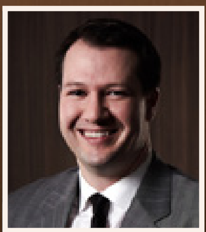

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3. The Developer decides to sell off lots or blocks to another builder/developer. Developers sometimes need funds to deploy elsewhere (buying a new site, paying a mortgage that is due, paying consultants for another project, etc) or they get made an ‘offer they can’t refuse’ on an entire project, a block within the project, or a few lots within the project and it makes more financial sense to sell than to build.

The great thing is, these options are not that bad. In the case of single-detached homes in the Toronto CMA, the miniscule 0.8% chance that a project is “closed” could potentially mean (in the case of 1 and 2 above) a delay in exiting, and that is why a “plus 1” is built into many of our deals. In the 3rd option, this (in most instances) is actually positive, investors get their principle exited early if the site or lots are sold to another developer or land owner!

Some of you might have caught that “in most instances” I threw into the previous paragraph; that might not sit well with people, so I looked at residential land and apartment land transactions closed in 2013, to see if they sold for more than the previous purchaser paid. I took 12 examples where the previous sale was available through the Marsh Report (information on major land sales). In all transactions the land sold for more than the previous owner paid, from the low of a 14% annual return to a high of an 81% annual return, with an average of 36% annual return! One property was purchased in 2012 for $1.05 million and sold this year for $1.90 million, and a second property owned by one of our clients was purchased for $7.0 million in 2011 and they sold it this year for $15.0 million!

We will save the discussion about increasing low-rise home prices, limited land availability, and Greenbelt legislation for another blog post on why ground related housing is doing so well, but this is a quick example of why low rise is low risk.

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