Real Estate Markets – Our Thoughts

By Ryan Gerrard & Chad Price

"If you're not confused, you don't understand things very well." – Charlie Munger

Vancouver real estate is a topic that we find ourselves discussing more and more with clients. We enjoy analyzing all markets, often finding the real estate market as exciting as the stock market, and we thought it would be worthwhile to share our thoughts on paper.

We all have a story of soaring real estate prices. Chad tells his personal story:

"Five years ago, my wife and I put down an offer on a house. It was accepted at $740,000; however, we walked away after the inspection revealed cracks in the exterior walls. It quickly sold for the same price. This same house just recently sold again for $1.4 million – an 89% increase in five years, or 17.84% per year."

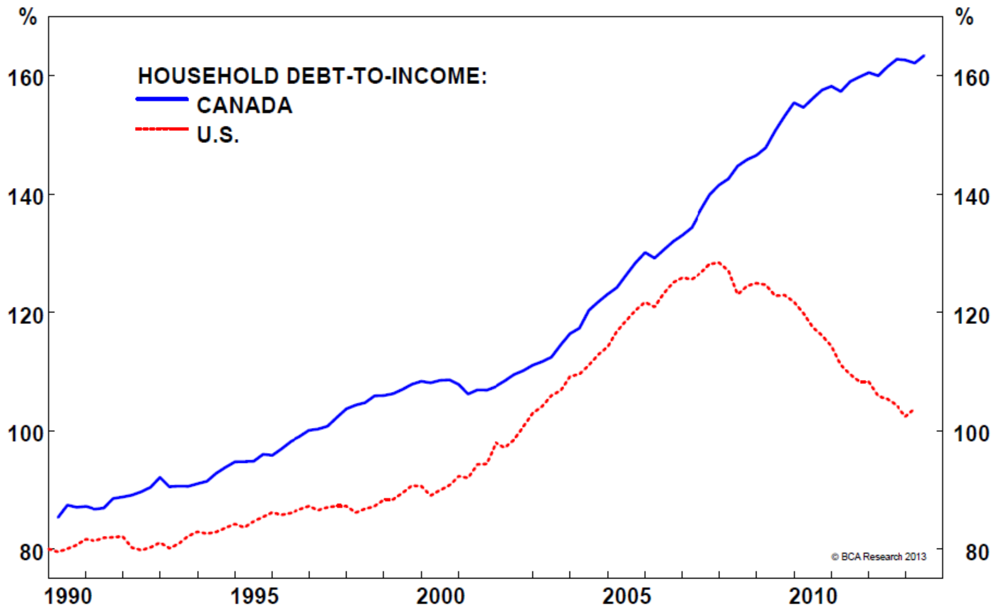
While we are both homeowners, we find the current state of Lower Mainland prices at once exciting, frustrating and concerning.

It is exciting to see an asset that we own increase in value, but has it created extra wealth for our families? We could sell our homes, but we both need to stay in the Lower Mainland. Selling an inflated asset to purchase another inflated asset becomes a wash unless we are able to downsize or move to a different market.

Consumer spending and debt concerns

Spend any time in the Lower Mainland and it's tough not to notice the number of highly priced homes, expensive vehicles, luxury shops and crowded, trendy restaurants. According to the Real Estate Board of Greater Vancouver (REBGV), Greater Vancouver detached home prices have risen 55.6% in the past five years as of March 2017. Auto sales are also booming in the Lower Mainland; however, the growth has been fueled by increasingly longer loans. A typical auto loan used to be 48 to 60 months, but finance companies have extended terms to 72 to 96 months, a maximum of eight years, according to a recent *Vancouver Sun* article ("Metro in debt: Non-bank or 'private' lenders feed (or rescue) debt-addicted homebuyers," November 22, 2016). It's nice to see a vibrant and wealthy local economy, but one has to wonder: have consumers become complacent with debt simply because they feel house rich?

Canadians continue to pile on a record amount of household debt, and this is concerning. According to Statistics Canada, at of the end of 2016 Canadians owed $1.67 for every dollar of disposable income (see graph that follows). This issue becomes far more concerning when considering how unaffordable cities like Toronto and Vancouver have become. How will the next generation be able to save money for the future when debt levels are so high and homes unaffordable?



Source: BCA Research, bcaresearch.com

The real estate market creates many jobs. A recent *Maclean's* article, "How Canada completely lost its mind over real estate" (April 7, 2017), explains that in BC, real estate and related fields such as construction and finance make up an astounding 40% of gross domestic product, compared to 12% for Canada as a whole. The housing market is keeping the BC economy strong, but we worry about the potential domino effect in the job market if housing markets were to soften.

Interest rates are near record lows, which has no doubt had an effect on housing markets and a role in pushing personal debt levels to record highs. Many leading economists and analysts believe that we have seen the low in interest rates – most notably, mortgage rates – and we agree with this analysis. Interest rates in the United States have begun to increase, and it is projected that they will continue to inch higher in the foreseeable future. It is speculated that Canada will soon follow. A March 2017 Ipsos poll on the topic of rising interest rates revealed some startling numbers:

- 52% of Canadians are concerned about their ability to pay their debts if rates were to rise.
- 38% of British Columbians are concerned about their ability to pay their debts if rates were to rise.
- 1 in 3 Canadians fear bankruptcy in the event of rising interest rates.
- 1 in 5 British Columbians fear bankruptcy in the event of rising interest rates.

The above results were higher than we initially would have expected; however, upon further analysis, we would argue that the BC results may be understated. It is likely that homeowners in cities like Vancouver and Toronto may not be as worried simply because the value of their home has increased so much. If interest rates continue to increase and home prices soften, it is plausible that people will become even more concerned.

While a sharp decline in home prices may be a low probability at this point in time, our biggest concern is the domino effect that could occur in consumer spending, jobs and income levels.

Buying a rental property

There are two ways to generate a return in real estate: price appreciation and collecting rental income.

Analyzing an investment in a rental property makes for interesting study. Rental income can appear large in isolation. For example, if you collect $1,500 a month in rent ($18,000 a year), it sounds fantastic, but it is important to consider what you're paying to get that income. If you have to pay $500,000 to purchase the rental property, then the *gross rental return* is only 3.60% per year. That return diminishes significantly when you subtract taxes, strata fees, maintenance, insurance and so on. This return calculation can also be used by current owners of rental properties to assess whether or not their investment still generates a good return based on current market value.

With the significant rise in home prices, achieving a decent return from a buy-and-rent strategy has become very difficult. We gathered a small sample from a few key markets to get an idea of the gross rental return.

	Average Monthly Rent	Average Sale Price	Gross Rental Return
Olympic Village	$2,100	$705,400	3.57%
Downtown Vancouver	$1,950	$807,000	2.90%
Midtown Toronto	$2,272	$779,796	3.50%
Average	**$2,107**	**$764,065**	**3.32%**

Source: Odlum Brown, Condos.ca. As of May 9, 2017.

If you were to think of a rental property as a business, like we would, then the next logical step would be to compare the rental property's yield to that of another investment. To compare apples to apples, one might look at a basket of diversified real estate companies such as the iShares Real Estate Investment Trust ETF, which had a yield of 4.95% as of May 11, 2017.

There are three important considerations regarding the above comments:

1. The examples do not include price appreciation.

2. People are comfortable with real estate because they know that they can always live in it if there were a problem, which makes sense to us unless one owns many rentals.

3. People are content to take out a mortgage or loan to purchase real estate or a business, but taking out a loan to purchase shares in a company is perceived as risky.

The last point is worth discussing further. Leverage plays a big part when investing in real estate. It is very common for people to use their own funds, say $100,000, and borrow the balance, say $400,000, to purchase a $500,000 rental property. The same can be said for starting one's own business. However, the idea of using those same metrics to purchase $500,000 worth of a group of businesses that trade on the stock market is often thought to be a crazy idea, which we find interesting.

House prices do not trade on an exchange like the shares of a company do, and this is likely a good thing. Investors can see the value of their investment portfolio change throughout the day, but imagine if you could see the value of your home trade throughout the day. Home prices fluctuate far more than people realize. Just imagine the immediate price decline when politicians implemented the foreign buyer tax in Metro Vancouver in August 2016. If people could see the value of their homes on a minute-by-minute basis, we believe it would cause much more volatility in home prices as people's emotions would cause them to react to short-term news. As a long-term investor, you could make the argument that stocks would be better off if they traded infrequently like real estate, as this would lessen the "noise."

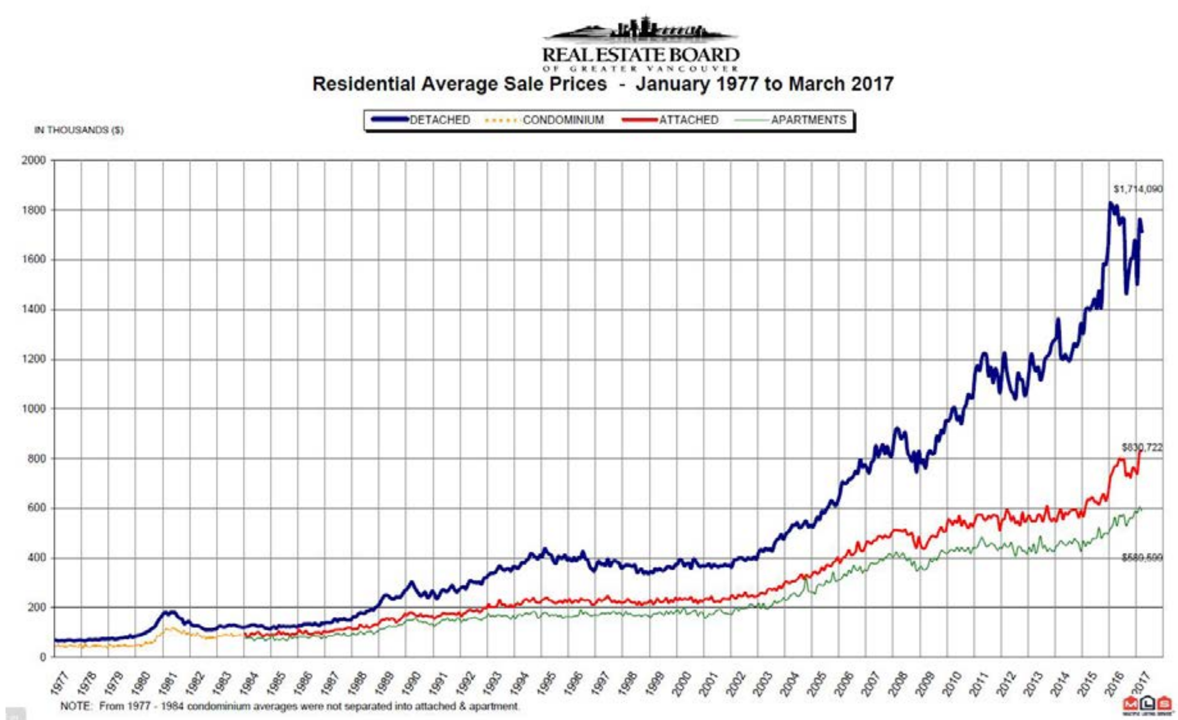
In our opinion, the biggest winners in the real estate market are homeowners who are near retirement and are willing to downsize or move from the Lower Mainland. Many people have already done this and many are considering it. Imagine selling a $1.5 million home and downsizing or moving from the Lower Mainland to purchase a $500,000 home. All of a sudden, you would have $1 million to invest and earn an income for retirement.

Food for thought

We did some calculations and found that since 1977, the average detached home sale price in Vancouver has increased from approximately $75,000 to $1,714,090 as of March 2017 (see graph below).This equals an annualized rate of 8.14%. If you project another 40 years at the same annualized rate of 8.14%, the average Vancouver home price in the year 2057 would equal $39,218,251!

Other notable comparisons since 1977:

- The price of a Big Mac increased 5.85%.
- The S&P 500 Total Return Index increased 11.11%.
- The S&P/TSX Composite Total Return Index increased 10.25%.
- Canadian inflation increased 3.50%.



Source: The Real Estate Board of Greater Vancouver

Conclusion

We're not making a call that Vancouver home prices will continue to rise or even decline. We do believe that home prices have been out of line with income levels in the Lower Mainland for quite some time. Interest rates are still very low, the economy is stable and foreign ownership interest remains strong, so there are reasons for housing demand to stay high. However, the ongoing rise in consumer debt levels is a concern.

What does the future hold for Lower Mainland home prices? Your guess is as good as ours. But one thing is for certain: we're thrilled to be living in one of the most desirable cities in the world!

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