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For real estate preconstruction buyers, a hard truth

CAROLYN IRELAND || APRIL 3, 2024

Paradise Developments is one of several new subdivisons being built just off of Conlin Rd E and Harmony St N in Oshawa, Ont.

For many buyers of preconstruction real estate, extravagant launch parties in downtown Toronto or bus tours to charming villages in rural Ontario are a distant memory.

Today many condo towers and new subdivisions are nearing completion and those preconstruction purchasers of houses and condo units are facing the challenge of closing on a deal they signed when the real estate market was on a high-octane run and mortgage rates were at historic lows.

Some are home buyers who struggle to line up the financing they need, while others are investors who are reluctant to take ownership of a property only to sell it at a significant loss.

Industry players are keeping a wary eye on this portion of the overall market.

Mark Morris, a real estate lawyer with LegalClosing.ca, likens the deals to futures contracts as many investors speculated that real estate prices would continue to rise by 10 or 15 per cent a year.

“They were priced at the peak at a significant margin above where the actual price of the product was.”

Those ventures did not pay off however, as interest rates climbed and real estate prices throughout Ontario tumbled from their 2022 peak.

As a result, turbulence in this segment of the market will continue until 2025 or 2026, Mr. Morris predicts.

In Toronto, Andre Kutyan, broker with Harvey Kalles Real Estate, says new condo buildings are nearing completion in neighbourhoods from Jarvis and Carlton streets in the core to Lawrence Avenue and Avenue Road in North York.

Some of the original buyers are also finding that appraised values are coming in significantly below the purchase price. That has sent people scrambling to find alternative financing, lease or sell as soon as possible, or seek legal counsel on the consequences of walking away.

While sales of condo units on the resale market have perked up in recent weeks, woes continue for buyers who bought preconstruction in the heady days between 2020 and 2022.

“This could be the wrench in an otherwise optimistic spring market,” says Mr. Kutyan, who believes the uncertainty in the segment could rattle the confidence of buyers in the resale market.

One small business owner sought out Mr. Kutyan’s advice after he paid $565,000 for a preconstruction condo with 370 square feet of living space downtown. The investor, who was approved for financing when mortgage interest rates were around the 2 per cent level, provided a deposit of $141,250 at the time.

The big banks, known as “A” lenders, are conservative in their lending these days and would not give him a mortgage for the amount he needs. The alternative, or “B” lender, sent an appraiser, who estimated the current value at $450,000, leaving the investor to close the gap between that amount and the original price.

In addition, he’s facing an additional $80,000 in closing costs and development fees.

In all, he needs to come up with an additional $141,000 just to keep his original deposit, and then he needs to pay the mortgage. The investor plans to take out a line of credit on his family house.

“People like this are losing their shirts,” says Mr. Kutyan, who advised the investor to seek legal and accounting advice. “They try to play real estate mogul when they really shouldn’t.”

Mr. Kutyan says some investors have been swayed by agents who specialize in the preconstruction segment and receive rich commissions and bonuses. With such heavy incentives, many are not looking out for the best interests of their clients.

Mr. Kutyan points out that buyers who sign a contract preconstruction in Ontario have a 10-day cooling off period to reconsider. During that time, they should be asking a lawyer to review the paperwork.

“Usually a lawyer will at least cap the development charges,” he says.

Some original buyers will “assign,” or flip the contract to another buyer, early in the process. But as a building nears completion, that avenue is closed off.

“These are the guys who are at the finish line.”

Leah Zlatkin, mortgage broker with Mortgage Outlet, says investors who buy condos with the intention of selling in the assignment market typically ensure that a clause in the contract allows them to do so. Many exit before the building is complete.

She’s seeing an influx of buyers who intended to live in the unit but now find the appraised value is coming up short.

“The real risk is in trying to close,” she says. “The unexpected has come up – and that is that your property is not worth what you paid for it.”

She recommends those clients tap into savings to provide a larger down payment if they can. If not, she advises them to borrow from a family member. The third option is to try to sell on assignment and the last resort is to secure financing from a private lender.

Those loans tend to come with high interest rates and fees, she cautions.

Some industry players say a few of the more well-established builders are quietly offering vendor take-back (VTB) mortgages to original buyers to help them bridge the gap at closing. Those arrangements tend to be backroom deals that are not widely available.

Mr. Morris says a number of builders are trying to help people close with a VTB for a term of one year or so. Buyers who purchased a property for their family home are more likely to be amenable to those measures, he says.

But the vast majority of people who are walking away are investors. They simply calculate their losses and figure that they are better off breaching the contract – even with the knowledge that the builder may sue them in the future.

“Many people who do the math and have a propensity for risk say, ‘I’m going to take the lawsuit option.’”

Mr. Morris says builders have two years from the discovery of the breach to go after the original buyer in court. During that time, they will resell the product and – if they sell for less than the price the original buyer agreed to – may sue them for the difference.

So far Mr. Morris has not seen a lot of legal action by builders but that may follow.

“They are biding their time until such time as they’ve sold, and their losses crystallize.”

Even builders who sue typically don’t claim land transfer tax, adjustment costs and other fees that buyers face if they complete the transaction, he adds.

The real problem, Mr. Morris says, is the fact that prices have stagnated.

“If the property value was twice what they paid, I guarantee you they would find a way to close,” he says of the investors.

Mr. Kutyan is concerned that builders may be forced to take back units and resell them, which will add to inventory.

“This could bring a flood of supply,” he says.

If the sellers become desperate and begin to offer fire sale prices, the spillover could unsettle the resale market, he adds.

Outside of the Greater Toronto Area, real estate agents are seeing people grappling with the difficulty of closing in small markets. If they decide to sell, there’s a very limited pool of buyers with the potential to step up.

Faisal Susiwala, broker at Re/Max Twin City Faisal Susiwala Realty, does much of his business in Kitchener-Waterloo and Cambridge, Ont. He recalls the large coaches that carried agents and prospective buyers through the area to the smaller communities where farm fields were rapidly being turned into building lots.

At the market’s peak, Mr. Susiwala says, high demand from buyers and little inventory in Cambridge, Guelph and Kitchener-Waterloo prompted people to expand their search. Agents from Brampton, Mississauga and Milton led the bus tours to such small towns as Ayr, New Hamburg, Baden and Woodstock.

In many cases, buyers were purchasing preconstruction homes with the intention of flipping the contract before building was complete in what’s known as an assignment sale.

"Realtors were so highly incentivized to shove those deals down the throats of buyers who all thought they were going to assign," he says. "Investors jumped into these coaches."

Investors in bucolic Perth County were told that they would be able to make money by selling the properties or renting them out.

There was no scope to ever be able to do that, Mr. Susiwala says, because the rural area has no industry and therefore few workers looking for homes.

"There are no buyers. There are no renters."

To make matters worse, some less responsible mortgage brokers signed off on a buyer's mortgage pre-approval at the time with scant evidence the buyer would have the means to pay – especially in an environment of higher interest rates.

As interest rates rose in 2022 and 2023, real estate prices began to come down.

Demand softened in Cambridge and Guelph and other cities that saw prices climb during the pandemic. With abundant inventory in the fall of 2023, prices fell 30 per cent in some areas.

Investors who paid $1,400 per square foot for a detached house found that they were trying to sell in an environment where a house on the resale market could be purchased for $1,100 per square foot.

In some cases, the original buyer is willing to walk away from a deposit, he says, and builders are then trying to find a new buyer. Mr. Susiwala has received a flood of e-mails from builders offering to sell below the contract price.

Mr. Susiwala has seen demand rebound in the resale market now that the Bank of Canada has held its key rate steady and many economists predict that cuts will come within a few months.

He expects many buyers from the Toronto area this spring as some people downsize from higher-priced homes. Often they have enough cash from the sale to purchase in Guelph or Cambridge without worrying about mortgage rates.

Detached three or four-bedroom houses that sold for $1.3-million at the market's peak in February, 2022 dropped to as low as $900,000 in the recent slump. Investors and builders trying to sell their newly built properties at a profit are not able to compete.

"It's not attractive enough for a prospective buyer."