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Real estate insolvencies in Canada set to surpass levels of global financial crisis

RACHELLE YOUNGLAI || AUGUST 11, 2024

The One Condo development project, in Toronto, on June 4.ABHIJIT ALKA ANIL/THE GLOBE AND MAIL

Residential property developers are facing rising insolvencies as they struggle with higher borrowing and construction costs – and industry experts warn the trend is likely to worsen as interest expenses remain elevated.

The number of insolvent real estate companies and projects has been rapidly climbing over the past year and is now on track to surpass levels of the global financial crisis, according to data from the federal Office of the Superintendent of Bankruptcy.

"This has been a long time coming," said Colin Doran, head of development advisory for commercial real estate firm Altus Group, who has been providing advice on distressed real estate projects for 15 years.

“There are no doubt more real estate projects in distress but it’s hard to tell how many can be worked out before ending up in an insolvency position. We expect there will continue to be more unsophisticated developers in trouble,” he said.

From January to May this year, there was an average of 20 real estate, rental or leasing insolvencies in Canada every month. Companies either sought bankruptcy protection or filed creditor proposals to make it easier for them to manage their debts under the Bankruptcy and Insolvency Act.

At this pace, Canada is on track to reach about 240 real estate insolvencies this year, which would be 57-per-cent higher than 2023 and 13-per-cent higher than 2009, when a wide swath of businesses ran into problems owing to the financial crisis and global recession.

And that does not include the number of developers and projects that have been forced into receivership for not paying bills. The Office of the Superintendent of Bankruptcy does not include receiverships by specific industry with its publicly available bankruptcy statistics. However, insolvency experts say they are seeing more projects go into receivership.

So far this year, the real estate sector accounts for 55 per cent of the receiverships recorded by Insolvency Insider Canada, a website that tracks the largest insolvencies in the country. That compares to 30 per cent last year and 33 per cent in 2022.

Sam Mizrahi’s luxury downtown Toronto condo tower The One has been one of the highest profile projects to default on its loans, with lenders owed $1.6-billion. And dozens of other developers have faced similar pressure from their lenders or have filed for bankruptcy protection.

“For the first time in a really long time in Canada, we are seeing some stress in the system,” said Syl Apps, who co-heads the Canadian operations of Hines Interests LP, a Houston-headquartered real estate firm that owns and manages about 850 properties in 30 countries.

So far, that stress is being felt amongst the relatively smaller developers or those that do not have the financial strength to weather interest costs that have soared since 2022.

Take Maplequest Ventures, a small developer that had plans to build housing on two parcels of land in Brampton, Ont. Maplequest took out a $24-million loan from KingSett Mortgage Corp. in 2017 to develop one of its Brampton sites into 147 townhouse units, 288 mid-rise apartment units and 1,599 high-rise apartment units, according to court filings.

The loan soon had an interest rate that was tied to a major bank’s prime lending rate, which moves in tandem with the central bank’s benchmark rate. By 2021, the KingSett loan had an interest rate that was the bank’s prime lending rate plus 5.8 per cent.

The loan eventually became much more expensive as the Bank of Canada raised interest rates from 0.25 per cent to 5 per cent over 2022 and 2023. During that time, the prime lending rate jumped from 2.45 per cent to 7.2 per cent.

This year, Maplequest defaulted on its loan to KingSett Mortgage Corp., as well as another loan with First Source Mortgage Corp., court filings show. The lenders lost confidence in the developer, triggering them to apply for a court-appointed receiver to oversee the project.

The court filings did not explain the reasons for Maplequest's default. The developer's CEO and its lawyer did not respond to a request for comment. KingSett did not immediately respond to a request for comment.

Some of the current problems in residential development can be traced back to 2017 when home prices were rising quickly in Toronto and demand exploded for new condos.

That year, there were nearly 31,000 preconstruction condo sales in the Toronto region, according to industry research firm Urbanation Inc. That was a record level and led to a surge in demand for construction workers and building materials – which started driving prices up.

The cost of construction rose 10 per cent from 2017 to 2018 in the Toronto region and 8 per cent across the country's major cities, according to Statistics Canada's residential building construction price index.

Developers quickly expanded, including less experienced builders who were able to sell out preconstruction projects as waves of mom-and-pop investors flooded the market.

At that point, investors were able to easily make a profit on the condo's price appreciation and the majority of them could cover their mortgage costs by renting their units out.

But the torrid pace of launches and sales helped mask problems that developers were starting to face. By 2021, low interest rates were fuelling the pandemic real estate boom and preconstruction sales soared to near record highs of 30,550 units in the Toronto region. By then, the cost of building was 34-per-cent more expensive across the major cities compared to 2017, according to Statscan data.

Then the pandemic slowed down development. Construction was hindered because workers had to socially distance on site. Developers delayed the start of construction – and they also delayed project launches.

This all added to the costs. Developers had to carry their mortgages for longer. Building materials were in short supply. And when the Bank of Canada raised interest rates, developers had to pay much more for their loans. Now that mortgages are more expensive, some preconstruction condo buyers are not able to qualify for the loan needed to close on their purchase, which is contributing to the malaise in the sector.

Today, the cost of residential construction is 81-per-cent higher across Canada's major cities compared to 2017 and more than double – up 107 per cent – in the Toronto region, according to Statscan data.

The higher borrowing costs are pushing a growing number of developers over the edge and lenders are no longer patient.

"A lot of lenders did that to the best of their ability. They entered into forbearance agreements, accepted some missed payments and basically worked with the borrowers," said Jeffrey Berger, managing director with restructuring and insolvency firm TDB Restructuring Ltd., whose company is working on between 10 to 15 insolvent real estate projects.

"Two or three years passed, and then it became clear that this was the new normal and things were changing and these loans had to be dealt with in some manner," he said.

That is what occurred with two plots of land on King David Inc.'s luxury condo development site in Markham, Ont. Part of the project is under construction, according to court documents. King David planned to continue developing on the other two plots and in December, 2021, it borrowed $54-million from First Source Financial Management Inc. The loan had an interest rate of the greater of 8.85 per cent or prime plus 6.4 per cent.

At the time, prime was 2.45 per cent. But by the time the loan was due in April, 2023, prime was 6.7 per cent. King David did not repay First Source by the deadline, according to court documents.

The lender cut King David some slack and agreed to a forbearance agreement, which gave the developer more time to repay the loan. The new deadline was July 8, 2023, the court documents said.

When the company failed to repay the loan by the new deadline, First Source provided a second forbearance agreement that extended the loan repayment deadline to Oct. 8, 2023. Then, when First Source learned that King David would not meet that deadline either, it provided a third forbearance agreement with a deadline of Dec. 8, 2023, that required the borrower to make a monthly interest payment in November.

King David failed to make that interest payment, according to court documents, and First Source decided to take action. In early December, it asked the Ontario Superior Court to appoint a receiver to take over the undeveloped land.

"The lender is concerned by the borrower's failure to advance the project. The property remains vacant," First Source chief executive David Mandel said in an affidavit filed with the court. "Despite having been granted forbearance since April, 2023, the borrower has been unable to refinance the loan or bring the loan back into good standing."

A lawyer for King David said the company is not insolvent or in receivership and that only this specific block of land, known as phase 2 and 3 lands, is in receivership. Asked what led King David to default on payments, the developer's lawyer, Avi Bourassa, a partner with Ross Nasseri LLP, declined to comment.

First Source did not respond to a request for comment.

The Bank of Canada started cutting its benchmark interest rate this summer, but borrowing remains expensive and there is little demand for preconstruction condos.

Developers used to be able to pass on their higher costs to buyers but prices have jumped so much that buyers will not buy the new condo units.

For those who have already bought investment properties, the purchase price is now at a point that an overwhelming share of new condo owners are burning cash because the rent they can charge is not enough to cover their mortgage payments and other expenses. For example, in the Toronto region, the asking price of a preconstruction condo has nearly doubled from 2017 through this year to around $1,345 per square foot, according to data from Altus. That puts the price of a 550-square foot condo at $740,000.

"There is less room for error. In the past, a developer could be good at sales and make their way to completion. Now they have to be good at all aspects, including planning and execution," said Altus' Mr. Doran.

"If developers were already struggling with lower margins impacted by planning delays, construction delays, cost escalation, then the impact of the rising interest rates were a double whammy to their proforma and project profitability," he said.