

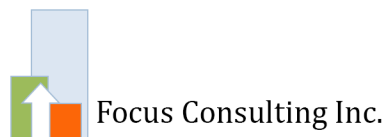
REPORT



Examining the feasibility and options for an inclusionary zoning policy in Toronto

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About the author

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The author retains responsibility for any errors or omissions and all views and conclusions in this study.

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Executive summary

The City of Toronto is exploring potential parameters to design and implement “inclusionary zoning” (IZ), a policy that would require the inclusion of affordable housing in new developments across the city. [An initial analysis](#) has been produced for the City of Toronto by N. Barry Lyons Consultants (NBLC). This paper draws on NBLC’s work, and furthers the analysis — using the same set of base assumptions, to the best extent possible — to examine possible parameters for an IZ policy that is not unfair or onerous for development, while also ensuring that the city can gain affordable housing units through new development.

This analysis considers three examples of “zones” in the city that typically have different prices for land and housing. These are:

- Higher-price/cost area (e.g., Downtown/Yonge-Eglinton)
- Medium-price/cost area (e.g., Toronto East/West)
- Lower-price/cost area (e.g., Etobicoke/Scarborough Centre).

For each zone, the analysis determines the degree to which, or if, a typical development can accommodate an IZ requirement based on revenues left after costs and reasonable profit. It determines the level of IZ that may be possible — both with and without rezoning to add density, and with and without any offsetting contributions in the form of fee waivers and other concessions typical of Toronto’s current Open Door affordable housing program.

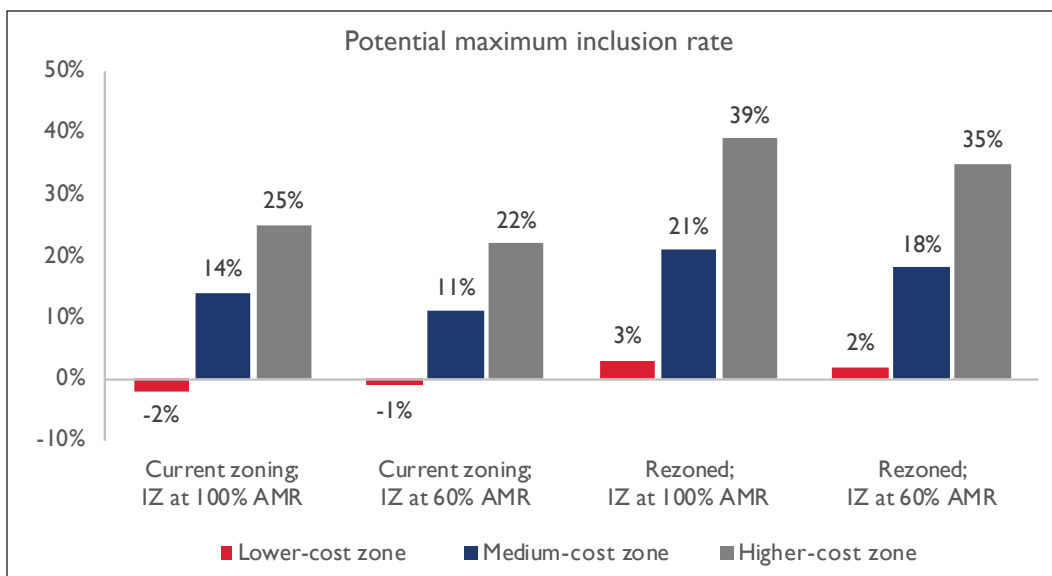
The analysis finds that there is considerable room for an IZ policy in Toronto, and could yield significant amounts of affordable housing being built as part of new developments. The analysis shows:

- In “as-of-right” (current zoning) development, there is room to require 10% of new units in medium-cost developments be made affordable, and 25% in high-value sites.
- In rezoned developments, the analysis supports requiring that 30% of all new units in high-cost areas be affordable, and that 15% of all new units in medium-cost areas be affordable.

- In lower-cost areas, the current market does not support the development of new affordable housing units through IZ. However, as the market in these areas continues to evolve toward higher values, intent to apply IZ in the future should be adopted.

This analysis also considers both depth of affordability and duration of affordability, and finds that more deeply affordable units are achievable under a sound IZ policy (albeit at slightly lower volumes) and that the housing created by IZ can and should remain affordable permanently.

These conclusions are shown in Chart 1 below.



Recommendations

1. Toronto should set IZ levels at variable rates, depending on the market capacity of different geographies across the city

Although the City of Toronto’s recent staff report¹ on inclusionary zoning recommends an IZ level of 20%, most new development activity is occurring in the higher-value areas, and these areas have the capacity to fully absorb an IZ requirement well above this level, especially in cases involving rezoning to substantially higher densities. The policy should be applied first in higher-value areas, and potentially at a higher inclusion rate.

1 City of Toronto. (2019, May 13). Inclusionary Zoning Official Plan Policy Direction. Retrieved from <https://www.toronto.ca/legdocs/mmis/2019/ph/bgrd/backgroundfile-133049.pdf>

The analysis also reveals that it is possible to include IZ in medium-value areas above the 10% level, as recommended by officials at the City of Toronto, especially in rezoned areas. As such, medium-value areas should also be included in the City's IZ policy.

Capacity to absorb the cost of affordable units through IZ is very constrained in lower-value areas, and so it may be prudent to set requirements at zero units until the market can better support the costs, except on a voluntary basis, where developers can be incentivized to build affordable units in developments using the Open Door offsets.²

As part of implementation, it will be necessary to define and map the areas to which the policy should apply. Establishing zones to which IZ will apply can be determined by price zone based on new sales and or tax assessment data. That task will also have to take into account the recent restrictions resulting from the passage of the Ontario government's [More Homes, More Choice, 2019 Act](#) (Bill 108), which restricts the application of IZ to specific areas of the city designated as Protected Municipal Transit Station Areas and areas to be designated under the Development Permit planning system.

Furthermore, it is also important to identify those areas that are currently not required to produce affordable units (due to poor feasibility), but to which IZ will be applied when the market in these areas is able to absorb the inclusion of affordable units in new developments. This would limit land value speculation in these areas. That is, the City's planning process must send a signal to the market and developers that IZ will be applied in low-cost areas when feasible, and well in advance of formally extending the policy to new areas.

2. IZ should apply to as-of-right as well as rezoned sites

The analysis reveals that in the higher- and even medium-value areas there is financial capacity to absorb some level of affordable housing through an IZ policy. Thus the policy should extend to both current zoned as-of-right applications as well as rezoning applications.

2 Toronto's Open Door program provides financial offsets that can include waivers on fees, development charges, parkland dedications and taxes to developers who include affordable housing in their developments.

3. An IZ policy should balance trade-offs between the development of more affordable units and the number of IZ units developed

The analysis examines two levels of affordability — 60% and 100% of average market rent (AMR) — and demonstrates that more affordable units can be built through IZ, but that in this case, fewer units would be built. For example, in rezoned areas, the analysis shows that high-value zones could absorb about 39% of the units being affordable, at 100% of AMR. However, at 60% of AMR, new developments in higher-value zones could provide about 35% at this more affordable rate. As the City develops its IZ policy, it would need to consider the trade-offs between the provision of more affordable units against the number of IZ units built.

The policy should emphasize rental supply, even when the development is a condominium. While it is possible to design an inclusionary zoning framework to allow affordable condominium ownership (e.g., Options for Homes), Toronto's primary housing policy challenge is the lack of affordable rental supply. Accordingly, the process should require and facilitate (as is done in Montreal) partnerships with non-profit organizations to own and operate a rental component in a larger condominium project.

Purpose-built rental construction at typical rental rates is barely viable, and has very limited potential to absorb the development of any IZ units, except at much higher “luxury buildings” (which are generally 200% above AMR). On this basis, it is not practical or desirable to impose the IZ requirement to applications proposing to build purpose-built rental at, or near, typical market rents.

4. Affordable housing developed through Toronto's IZ policy should be perpetually affordable

The policy should seek to facilitate permanent affordability, rather than some time-limited requirement such as 25 years. A limited period creates uncertainty for both residents and private owners and adds an administrative burden on the City to enforce the time-limited nature of IZ units, while contributing to the future erosion of affordable housing supply. This analysis shows that it is possible to develop IZ units that are permanently affordable.

To keep IZ units affordable in perpetuity, it is important to understand who will manage these units. While a rental developer-owner might hold and manage the affordable units, it is assumed that in condominiums IZ units would sell to a non-profit owner operator either in an offsite development or in a separate strata corporation. A non-profit would acquire these units based on 100% of the lending value, which is supported by the net operating income (NOI) generated at the assumed affordable rent threshold (so the non-profit would borrow to finance this transfer).

5. Toronto's IZ policy should be phased in

The implementation of an IZ policy will inevitably create some reaction and opposition from the development industry. However, once fully implemented, the requirement will become capitalized into costs as a cost of doing business, potentially with some downward pressure on land values. This is no different from school fees or parkland dedications that were historically established in the planning and development process, and are now fully accepted.

To allow the market to capitalize the cost of affordable inclusion, gradual phasing will be required.

Given that Toronto should have IZ levels set at variable rates across the city, the following is a recommended strategy for the City to phase in its IZ policy:

- On sites with zoning in place, IZ could be phased in over a four-year period in 5% increments, starting in 2021.
- On projects that seek rezoning, the policy can be implemented on any rezoning application made after January 1, 2020. For these projects, a higher initial rate might be required (e.g., 10% initially rising by 5% annually to 20%).

1. Introduction

The City of Toronto is exploring potential parameters to design and implement a policy to require inclusion of affordable housing in new and rezoned developments across the city. [An initial analysis](#) has been produced by N. Barry Lyons Consultants (NBLC) for the City of Toronto. This analysis draws on NBLC's work and, to the extent possible, uses a similar set of base assumptions to examine possible parameters for an IZ policy that is not unfair or onerous for development, while also ensuring that the city can gain affordable housing units through new development.

The paper first reviews the conceptual basis for IZ. Subsequently, it explores the feasibility of IZ at different locations and levels of affordability across Toronto. The paper analyzes how rezoning, to create additional value, can help to accommodate IZ units. It also briefly examines how this may work in cases of purpose-built rental development (versus condominiums). Lastly, it concludes with a summary of insights, presented as recommendations.

2. The case for inclusionary zoning

Ontario municipalities (through the [Planning Act, 1990](#)) have legislated obligations to anticipate and plan for growth, and to ensure a sufficient supply of housing, including an appropriate range of dwelling types and sizes and a range of prices, as required by the growing population. This is the basis and logic supporting the development and implementation of an IZ policy in Toronto.

While the municipal planning system can *plan* for growth, it cannot deliver the necessary outcomes that the public needs. Although the planning system is reliant on market dynamics to implement the City's plan, these dynamics typically do not deliver the right quantum and mix of housing type and price that the plan identifies. As a consequence, there tends to be an insufficient stock of housing units with lower rent units, and a "missing middle" in terms of intermediate densities (between detached homes and high rise).

This is typically characterized as market failure – a phenomenon in which there is an "inefficient" allocation of resources and a disequilibrium in the housing market, and where externalities such as unaffordable housing and homelessness

may occur. Many low-income households lack the income to have “effective demand,” and thus are overlooked in market pricing mechanisms. Inclusionary zoning, within the City’s planning framework, can help to fill this supply gap.

IZ is also a way to avoid spatial sorting by price, which is often characterized by increasing concentration of lower-income housing and households in certain areas.³ Avoiding such concentrations and their consequences can be facilitated by broad-scale IZ policies.

Public process of creating value

A critically important aspect of the planning process, the jurisdiction over planning and development approval, is the way that **the public process creates land value.**

Land has no inherent commercial value until a public approval process specifies how it can be used. Provinces have delegated this authority to the municipal, local level; consequently, **local government is the gatekeeper of development approvals and thereby the creator of land value. This is an exclusive and critical authority — one which municipalities dramatically underutilize.**

To illustrate this concept, land used for parking is valued based on the capitalized value of ongoing parking revenues. If the municipality approves a multi-story parkade, such parking revenues increase, and land values rise to reflect the increased revenues, less the cost to construct the parkade. And similarly, in the case of residential development, it is the process of designating and approving the residential use, and the scale of that use, that generates value.

Land value is the result of gross revenue (from the approved use and density), less hard and soft costs, less developer/builder profit. For this reason, it is defined as a “residual value.”

Where prices are rising (due to market demand pressure), this will initially generate a larger development surplus or profit. The past decade has seen dramatic increase in home prices and, as a result, for developers that purchased land at much lower costs many years ago, substantial surplus will have been generated.

3 See for example Hulchanski, D. (2010). *Neighbourhood Trends in Divided Cities: Income Inequality, Social Polarization, & Spatial Segregation. A Selected Bibliography*. Toronto, ON: Cities Centre, University of Toronto.

However, in a competitive market, where market dynamics result in “excess profit,” these will gradually flow into land values. Prospective developers will anticipate higher gross revenue, subtract hard and soft costs and profit margin to arrive at a maximum value that they will bid for the land. See Illustration 1.

Illustration 1: Assume a multi-unit residential development

- Development generates a gross yield of \$50 million
- Total hard and soft costs are \$30 million
- Profit margin at 15% (of gross yield) is \$7.5 million

Thus land value is \$50 million minus \$30 million minus \$7.5 million = \$12.5 million.

In Illustration 1, a prospective developer acting rationally would not pay more than \$12.5 million for the land. An aggressive competitor that anticipates that market pressures will increase gross yield to \$55 million might increase their bid price for the land.

Meanwhile, a prescient developer that purchased and banked land many years ago may have paid only \$5 million. They will generate a much larger profit of \$15 million (\$7.5 from development margin and \$7.5 million from lower land cost), offset by any ongoing carry costs or opportunity costs (money used to buy land could have been invested elsewhere) and by any capital gains tax.

Land speculation and inflation

While developers are frequently identified in a negative light, as many are perceived to, and indeed often do, generate significant profits through land development, **in most cases it is a poorly constructed public policy framework that enables and facilitates land speculation.**

The legislated planning process establishes the regulatory framework for development and uses two main regulatory mechanisms: an Official Plan (OP), which is a broad policy statement of anticipated growth and how certain lands will be designated and brought on-stream or reused; and a zoning bylaw to specifically regulate development and use.

The zoning bylaw prescribes the parameters applicable to any piece of property, such that prospective developers know what is permitted and can plan their investment and development under those rules. In Illustration 1, the zoning bylaw will have established the scale and density of the permitted use that generates the \$50 million in gross revenue. That specific zoning established the value (subject to prevailing market conditions), which used the development right to secure the revenues underpinning the land value (of \$12.5 million).

OPs are forward looking and anticipate both growth and reuse, such as intensification. For example, the OP might designate arterial main streets or the area surrounding a future transit station for intensification, implying some higher density.

In effect, the OP statements are sending a signal to the market that the municipality is willing to rezone and allow a higher use of certain properties than that allowed under current zoning. **On the basis of this OP signal, potential developers will anticipate a higher density and accordingly higher yield (profit).**

In a competitive market, prospective developers will increase the value of their bid for land based on anticipated greater yields. Unlike Illustration 1 (where zoning is already in place), there is no certainty (but reasonable expectation) that the anticipated higher density and use will be approved; so bidding will involve some degree of risk, and valuations will reflect some risk based discounting. Illustration 2 presents this scenario.

Illustration 2: The OP proposes intensification, so a rezoning process may pursue an application to double the density (and the yield) compared to current zoning

- Development now generates a gross yield of \$100 million
- Total hard and soft costs are \$60 million
- Profit margin at 15% (of gross yield) is \$15 million

Thus land value is \$100 million minus \$60 million minus \$15 million = \$25 million (less some risk premium).

In this case, the higher yield (\$25 million vs. \$12.5 million as in Illustration 1) is anticipated because an open and transparent process (the OP) has established this potential. Now a rational prospective developer will recognize the greater profit potential and will accordingly increase their bid potentially up to the new residual value of \$25 million (less some risk factor).

The main beneficiary of the rezoning is the current landowner, who reaps a windfall profit without doing any work, while the purchasing developer has done work to apply for rezoning.

Although a growing population requires increases in allowable density, the policy framework provides for this needed density without a way to ensure that the public benefits from these changes; as a result, it unintentionally encourages increasing land values and speculative behaviour.

The public process encourages and facilitates speculative land acquisition by signaling intent to permit a higher use and yield. Meanwhile the municipal council, the community and the taxpayer do not share in this value increase, beyond the downstream higher property taxes that will result (and the federal government may also benefit from a capital gain tax on the property/land sale).

Inserting conditions into the OP and zoning process

This scenario can be adjusted to capture a “public gain” against the new value increase/uplift **only if specific and explicit conditions are included in the OP and in the zoning bylaw.** This sends a clear and transparent signal to the market about the associated cost, or quid pro quo linked to higher use or density. As a result, this will suppress land value and remove speculative inflation in land values.

If, for example, the OP prescribes that on all sites over a certain size, or on all sites creating more than a minimum threshold number of dwellings, a specified proportion must meet the prescribed affordability criteria (or some other quantifiable community benefit), the prospective developer will estimate these costs and factor these into the potential future value and bidding process. Effectively, the IZ cost will be capitalized into land value, which will therefore be lower.

Conceptually, the establishment of certain conditions can be applied both in existing zoning (as-of-right) conditions, as well as in rezoning, although it

is rezoning and increasing density that have the greater potential to enhance potential development value.

The planning and permitting process can only minimize speculation and windfall gain and ensure that the enhanced land value is shared for public benefit if IZ requirements are explicit and made available in advance.

Conceptually, this is reflected in a density bonus provision, such as Section 37 in Ontario's Planning Act, which authorizes the municipality to negotiate some level of community benefit in exchange for increased density. However, under Section 37, the form and cost of the desired community benefit is not prescribed in advance, and is a negotiated element. So potential developers experience significant risk, especially if they underestimate form and cost of the community benefit and bid too high for the land.

For example, Montreal has had a “voluntary” inclusionary zoning policy since 2005, but it is quite explicit about the desirable inclusion (15% at affordable market and 15% for social housing, developed in partnership with a community non-profit) such that these costs are explicit and transparent for prospective developers. Community advocates in Montreal draw on the policy by participating in the approval process, effectively making the voluntary policy a de facto mandatory requirement to secure community approval in the planning application process.

The City of New York transitioned from a voluntary to mandatory IZ policy in certain neighbourhoods in 2015 and has a detailed prescription of affordable IZ requirements — essentially “pre-zoning” these areas. Such “pre-zoning” can be beneficial to the development process by eliminating risk and uncertainty and quantifying the basis of costs that must be absorbed.

Capturing the “public gain”

The most effective way to capture a share of the value uplift for public gain is by explicitly specifying the IZ requirement well in advance of any potential (speculative or anticipatory) land purchase.

For example, if there were a condition in the OP that exchanged an increase in the allowable density of the project for the requirement that 20% of the total

density would create affordable housing (at some explicit prescribed rent level, such as 80% of the AMR), the residual land value would be reduced.

Prospective land buyers will insert this cost into the residual land value calculation and will accordingly adjust their maximum bid downward.

As shown in Illustration 3, the residual land value is now reduced to \$14.375 million (vs. \$25 million if there were no inclusionary zoning requirement, but more than the \$12.5 million in the Illustration 1 base case). This represents the maximum a rational developer would bid.

Illustration 3: The OP proposes intensification, but also prescribes that in exchange for the higher density, 20% of the total units developed would be for affordable rental purposes.

- Development generates a gross yield of \$80 million from market units + \$7.5 million from affordable units = \$87.5 million (compared to \$100 million if no IZ requirement);
- Total hard and soft costs remain at \$60 million;
- Profit margin at 15% (of gross yield) is \$13.125 million.

Thus residual land value is \$87.5 million minus \$60 million minus \$13.125 million = \$14.375 million

Ancillary benefit of an inclusionary zoning policy

Beyond achieving the policy objective of adding new rental housing at moderately affordable rents, an IZ housing policy can be an important instrument in addressing the impact of rising home values, which crowd out new affordable rental development and exacerbate affordability issues (both for low- and moderate-income households).

As illustrated above, the existing planning process and legislative framework (in Toronto and more broadly) has a direct and unintended effect in causing land price speculation. An IZ policy can be an effective mechanism in correcting and neutralizing this problem.

This is the greater benefit of an IZ policy — if well designed and implemented, it can be an effective instrument in mitigating land speculation that capitalizes on potential increased land value from potentially higher density and yield (and also in the case of transit-oriented development, where public infrastructure investment also enhances local land values). In doing so, it can contribute more broadly to preserving and enhancing affordability across the housing market.

Implementing an inclusionary zoning policy

There are many considerations that need to be assessed in the design of Toronto’s IZ policy. For example, it is important to ask:

- How is an affordable outcome understood (level and duration of affordability) — what is the definition of “affordable”?
- What is the proportion/percentage of total Gross Floor Area or total units in the property that should achieve the prescribed affordable specification?
- What is the extent of geographic coverage — would it apply universally across the entire jurisdiction, or be targeted to certain neighbourhoods?
- Would IZ apply to any and all new developments or only to multi-residential developments, above some prescribed minimum size/scale of development (e.g., impossible to apply to individual detached homes, but could be applied to a new subdivision)?
- Would IZ apply to all new development satisfying previous criteria, or only in cases where a zoning/planning change is required (i.e. is as-of-right development that builds under preexisting zoning exempted with IZ restricted to only added density, or are the IZ requirements for the whole building)?
- Is the IZ requirement to be absorbed within the development cost (i.e. absorbed by developer), or is there some level of offset or compensation for the directly associated cost (e.g., using the current Toronto Open Door offsets that waive fees and charges, or as in Montreal, where net cost is funded under a social housing capital program)?

- What phasing is appropriate for the market (and land purchases) to adapt and capitalize the effect of inclusion into land values?
- Should developers be able to satisfy the obligation through off-site development?

Some guiding principles for an inclusionary zoning policy

The following guiding principles can help guide the development of Toronto's IZ policy and are used as a foundation for this paper's detailed financial feasibility analysis:

- Given the critical need to expand the stock of affordable housing in Toronto, as a general principle, the City's IZ policy should be applied as broadly as possible. For practical reasons, this may include establishing a minimum threshold for projects upon which IZ would apply. For example, under the current legislation, any sub-division or structure less than 10 units would be excluded.
- The policy should seek to optimize affordability. That implies permanent affordability, rather than some time limited requirement such as 25 years. A limited period creates uncertainty for both residents and private owners, and adds an administrative burden on the City to enforce the time limit. Importantly, a time limited requirement would contribute to the future erosion of affordable supply.
- In cases where the developer is not in the rental business (i.e. a condominium developer), the simplest model is for the IZ units to be sold (at net cost) to a non-profit provider so that it can own and operate IZ units in perpetuity.
- To maximize the yield generated from IZ and to promote the development of mixed-income communities, the policy should be applied on-site. However, some exceptions could be made for off-site provision of units in appropriate circumstances.
- It is critically important that any inclusionary zoning policy be phased in to enable the land market to adjust to these new costs. This might involve a graduated rate of inclusion, rising over time.

3. Methodology and approach used to model impacts and options

This paper draws on the analysis that NBLC has undertaken for the City of Toronto. Like the NBLC analysis, this analysis treats land as a residual value and seeks to extract the cost to cover an inclusionary requirement from development surplus.

This analysis errs on the side of overstating hard and soft costs and underestimating the potential and impact of an IZ policy. These findings should therefore be seen as a very conservative estimate of the IZ levels the market is able to withstand.

In addition to assessing if there is sufficient residual value to accommodate an IZ requirement, it also determines the level of inclusion that may be possible, both with and without any offsetting contributions toward the cost of inclusion, and across three different value areas.

This analysis uses a typical illustrative development of 100 units, with an equal mix of one- and two-bed units. This base case type and scale of development is used across three case study areas:

- Higher-price/cost area (e.g., Downtown/Yonge-Eglinton)
- Medium-price/cost area (e.g., Toronto East/West)
- Lower-price/cost area (e.g., Etobicoke/Scarborough Centre).

This paper uses a consistent size building and Gross Floor Area (GFA), but because densities are already higher in high-value areas, the land area required is smaller in such areas. This analysis initially uses a Floor Space Ratio (FSR) of 4.0 rather than 2.5 in high-value areas.

The main variations between each case are the potential sales or market rent values. Because costs are relatively consistent across zones, gross revenue increases result in higher land values.

A number of simplifying assumptions are used to create a pro forma without using detailed line elements (e.g., rather than estimating all professional and public fees and charges, soft costs are allocated at 60% of hard costs).⁴

A base case is used with appropriate area adjustments to reflect different prices and land values across each zone. It is subsequently used to examine the impact of introducing an IZ requirement, and then to explore the impact of graduated levels of inclusion and increasing levels of affordability. These scenarios initially assume as-of-right/current zoning density (at base density of 2.5 FSR to land size in the lower- and medium-value areas and 4.0 in the high-value area). Subsequently, the implications of rezoning to higher density are examined. In reality, most development will use the later anticipated rezoned density, but the initial steps help to reveal how the planning process contributes to land value speculation.

In addition, prevailing land prices (based on sales data for land area for sites designated for apartment development) in each area have been used for the analysis to determine the portion of the residual surplus available to cover IZ requirements. This is then compared to the amount of surplus required to absorb the full cost associated with the creation of IZ units (initially assumed at 20%, as in the NBLC analysis). As the land prices used in the analysis are likely higher than actual historic cost incurred by developer, this assumption creates a conservative estimation of the potential of an IZ policy.

Where insufficient residual surplus is available for a 20% inclusionary zoning requirement, the data is recalculated to reflect the surplus available to determine the maximum IZ rate feasible.

Finally, the potential to achieve a 20% requirement is estimated using potential offsets, such as waiving property taxes, waiving development charges, etc., as established in the City of Toronto's Open Door framework.

4 A detailed review of actual soft costs for a sample of projects suggests that the ratio of soft costs to hard costs may be in the order of 40-50%. This is based on including taxes and insurance during construction, professional consultant fees, and a wide range of public fees and charges, including rezoning fee, development charges, and parkland dedication. Section 37 fees are excluded. However, NBLC has suggested that a higher allocation better reflects recent experience, so a higher ratio of 60% has been adopted in this analysis to minimize the variation on assumptions in the two studies, and to ensure a conservative estimation of inclusionary potential.

Estimating potential net proceeds (surplus) before land and IZ

This paper assumes a masonry construction mid-rise with underground parking (costs will be lower for wood-frame with surface parking). A range of values are used based on prevailing condominium costs, sales values, and rents. To the extent possible, the assumed values are similar to those used in a separate IZ Impact Analysis prepared for the City by NBLC (which shared its base assumptions to avoid variations based on using different assumptions).⁵ See Table 1 for detailed assumptions.

It is assumed that hard costs are consistent, except for the high-value zones where a 10% cost premium is applied, as recommended in the Altus Cost Guide and used by NBLC.

The cost to construct parking is added, with parking ratios varying across the three areas. The costs to include parking are higher in the lower-value areas due to larger parking ratio, and subsequently the sales value or monthly parking rates similarly vary. For cost calculation, a gross area of 400 sq. ft. is assumed for each parking space (includes space and circulation area).⁶

The base case tested here assumes a standardized 100-unit project with a blend of one- and two-bed units averaging 750 sq. ft. This is grossed up (at 85% net-gross ratio) to estimate a GFA against which construction costs are applied.

Total construction costs, soft costs and a 15% profit margin are estimated for each site.

The duration of affordability (e.g., units held affordable for only 25 years, versus perpetual affordability) of IZ units must be considered. Valuing future revenues as well as any residual value going back to the developer at the end of the compliance period is challenging, both analytically and administratively. It relies on linear assumptions on rate of price appreciation and on assumed discount rate. For simplicity, it is assumed that all inclusionary zoning units are designated as permanent.

5 While using a consistent set of base assumptions, it is noted that the methodology here differs from that used by NBLC. NBLC selected a cross-section of specific sites with localized density and scales varying by site to assess the impact of IZ; this analysis uses a standardized “typical” development of 100 units applied across three value areas.

6 Parking ratios are highest in low-value zones, so this has a larger impact for the cost of parking. This results in total cost for medium-density zones (at half the parking requirement, space and cost) being lower than that for low-value zones.

| Table 1: Key assumptions (primarily drawn from NBLC) | | | |
|---|---|---|--|
| | Lower-price/cost area (e.g., Etobicoke/Scarborough Centre) | Medium-price/cost area (e.g., Toronto East/West) | Higher-price/cost area (e.g., Downtown or Yonge/Eglinton) |
| Standard assumptions all areas | | | |
| Ave unit size sq. ft. | 750 | | |
| Net/gross ratio | 0.85 | | |
| Soft cost (% of hard costs) | 60% | | |
| Developer profit | 15% | | |
| U/G parking gross area per spot sq. ft. | 400 | | |
| U/G parking cost sq./ft. | \$135 | | |
| Cap rate (affordable rental) | 0.04 | | |
| Cap rate (market rental) | 0.05 | | |
| Operating expense ratio (market) | 0.36 | | |
| Operating expense ratio (affordable) | 0.40 | | |
| Residential property tax (new rental) | 0.636 | | |
| Mortgage rate (rental) | 3.5% | | |
| Mortgage factor /\$1,000 loan | \$4.99 | | |
| CMHC average market rent (one/two)/month | \$1,380 | | |
| Vary by price zone/area | | | |
| Hard cost per sq. ft. | \$225 | \$225 | \$250 |
| Floor Space Ratio (FSR) | 2.5 | 2.5 | 4.0 |
| Parking ratio | 0.90 | 0.60 | 0.30 |
| Condo sales price sq. ft. | \$650 | \$800 | \$1,100 |
| Rent rate sq. ft. | \$3.00 | \$3.80 | \$4.20 |
| Sale price per parking spot | \$35,000 | \$50,000 | \$70,000 |
| Rent rate per parking spot/month | \$85 | \$125 | \$175 |
| Site parameters | | | |
| Lot size sq. ft. | 35,500 | 35,500 | 22,185 |
| Floor Space Index (FSI) | 2.5% | 2.5% | 4.0% |
| Gross Floor Area (GFA) sq. ft. | 88,750 | 88,750 | 88,740 |
| Liveable Floor Area (LFA) sq. ft. | 74,994 | 74,994 | 74,985 |

While a rental developer-owner might hold and manage IZ units they build, it is assumed IZ units in condos would sell to a non-profit owner-operator, and establish a separate strata corporation for these units. It is assumed that a non-

profit would acquire these units based on 100% of the lending value, which is supported by the NOI generated at the assumed affordable rent threshold (so the non-profit would borrow to finance this transfer). In addition, they may require some capital funding to fund an equity down payment.

Using these base assumptions, the potential yield from development before considering land costs is determined. These steps are shown in Table 2, using a medium-value site area.

| Table 2: Illustrative case and steps to determine residual value | | |
|--|---------------------|------------------|
| | Medium-cost zone | Per unit |
| A. Construction costs units | \$19,968,750 | \$199,688 |
| B. Construction costs parking | \$3,239,730 | \$32,397 |
| C. Total construction | \$23,208,480 | \$232,085 |
| D. Soft costs (at 60% hard costs) | \$13,925,088 | \$139,251 |
| E. Developer/builder profit (15% of gross sales) | \$9,449,213 | \$94,492 |
| F. Total costs (C+D+E) | \$46,582,781 | \$465,828 |
| G. Gross revenues | | |
| H. Market value (condo) | \$59,995,000 | \$599,950 |
| I. Revenue parking sales | \$2,999,750 | \$29,998 |
| J. Gross revenue = Market value (H+I) | \$62,994,750 | \$629,948 |
| K. Surplus available for land and IZ (J-F) | \$16,411,969 | \$164,120 |

Estimating the cost to absorb inclusionary zoning requirement

To estimate the costs that developers will incur to absorb some specified proportion of affordable units, it is assumed that these will be rental units. Rent amounts are set at a prescribed “affordable level,” usually well below the full potential market rent that might be achieved (e.g., 60% AMR vs. 100% AMR). Note that full market rent potential for newly constructed modest units would be much higher, in the order of 135%-140% of the AMR, and much higher for luxury rentals.

To facilitate this calculation, a single consistent AMR is used across all three areas (blended one- to two-bedroom City of Toronto average unit size) rather than varying for average in each local CMHC rent zone. Based on 2018 CMHC rent survey, for the City of Toronto, the blended one-two-bed average rent is \$1,380.

Again, as a simplifying assumption, the affordable IZ units are constructed at the same cost as the market condominium units. However, IZ units would likely be built at a slightly reduced finish standard, and may benefit from certain cost savings — these are introduced later as potential offsets. The assessment also assumes that 20% of the parking cost and use is allocated to the affordable rental. Again, in practice this might be reduced, and more parking might be reserved for the market condominium units. These simplifying assumptions increase the estimated cost of inclusionary zoning and therefore represent a conservative approach.

While giving up 20% of the units to build affordable rental versus market condominium units, the developer does not lose all of the net condo yield; it is simply replaced on the 20% units by a lower affordable rental yield. Even though at a sub-optimal rent (i.e., compared to potential full market), the affordable rental units do generate some cash flow and NOI. This NOI is converted to a capital value using the prevailing capitalization rate (as used in the industry to value an income generating property). The capitalization rate applied to the affordable units is however slightly higher (5%) versus that which might apply to full market (4%), which is used later in examining a rental rather than condominium project. As shown in Table 3, the capitalized value of each affordable unit is \$205,330, compared to the gross yield on the condominium unit of \$629,948, a difference in revenue of \$424,600. However, this cost is spread across the 80 full-priced condominium units, so averages roughly \$106,000.

Of course, at lower more affordable rents, the NOI and thus capital value is reduced (and the cost to absorb is increased — this is explored in subsequent simulations).

In allocating floor area (units) for affordable inclusion, the developer is forgoing the condo sales revenue (or in case of rental the capitalized market rent revenue, which will yield a much higher capitalized value than the

affordable level). The developer is, however, generating some revenue from the affordable component to partially offset this forgone amount.⁷

Thus, the net cost to absorb the IZ units is the forgone condo revenue *less* the net value generated by the affordable units, spread across the remaining market units (Table 3). It is this amount that must be covered by the residual gross revenue surplus discussed above.

| Table 3: Net value of affordable units and cost to absorb | | |
|--|--------------------|------------------|
| | Project | Per unit* |
| Rent/month | \$27,600 | \$1,380 |
| A. Gross rent | \$331,200 | \$16,560 |
| B. Parking revenue | \$18,000 | \$900 |
| C. Gross revenue with 2% vacancy (A+B x 0.98) | \$342,216 | \$17,110 |
| D. Operating expenses at 0.40 of gross (C x 0.40) | \$136,886 | \$6,844 |
| E. NOI (C-D) | \$205,330 | \$10,266 |
| F. Lending value (at cap rate of 5% on affordable rents) | \$4,106,592 | \$205,330 |
| G. Forgone condo revenue with IZ (medium condo sale price) | \$12,598,950 | \$629,948 |
| H. Net cost to development to absorb IZ (G-F)* | \$8,492,358 | \$424,618 |
| <i>*Note while presented here on a per unit basis, the IZ cost for 20 affordable units is absorbed across 80 market units.</i> | | |

The final step in the assessment is to assess how much of the residual surplus is required to cover land cost, versus being available to cover the cost of absorbing the IZ requirement. This requires a review of the likely land cost (bearing in mind that many developers may have acquired historically at a lower value).

Estimating land price

Land costs will vary based on the location, the time frame land was purchased, and the holding costs, and these are impossible to estimate. Accordingly, the analysis draws on recent sales data for sites planned for multi-residential apartment developments to estimate likely land price if the site were purchased

⁷ If ownership is retained by the developer, they will generate the equivalent income, albeit spread over time; in event the affordable units are transferred into a non-profit, they will be sold at this value. The non-profit would then borrow this amount and service the associated debt via revenues received. Again, for simplification this assumes 100% loan to value, as currently permitted under CMHC's Rental Construction Financing Initiative. If a lower loan-to-value is required by the lender, the acquiring non-profit may require some capital subsidy to cover this down payment.

today. As most developers will have purchased some years ago, this too overestimates the actual cost and is a conservative assumption because it uses the worst-case price (i.e., if purchased today).

This assessment uses sales data for apartment-planned sites that have transacted over the past five years, as provided from an industry-based data set (a subscription service for real estate data). These values are provided in the data set at a price per square foot of land area. It is more typical to use the price per buildable square foot (sq. ft.), which depends on the density allowed on that site. Here the land area value is converted to a cost per gross buildable sq. ft., based on the assumed pro forma densities of 2.5 and 4.0 FSR.

Based on the recent sales data for apartment property sites, the current land price per sq. ft. of land area in the various areas of Toronto is:

- Low at \$140/sq. ft.
- Medium at \$300/sq. ft.
- High at \$800/sq. ft.

The data source does not provide details to determine the cost per buildable sq. ft. However, the implicit values for cost per buildable sq. ft. are estimated here using the illustrative sites and related densities, providing a buildable sq. ft. cost in the various areas of Toronto of:

- Low at \$56/sq. ft.
- Medium at \$120/sq. ft.
- High at \$200/sq. ft.

The residual surplus — calculated by determining the difference between sales revenues and costs and profit — is available to cover these land costs. A project is viable if the development surplus exceeds the anticipated land prices at the assumed GFA for the site.

Process for estimating the cost of absorbing inclusionary zoning requirements

| Table 4: Illustrative case to determine feasibility of inclusion | | |
|--|--------------|-----------|
| <i>(Based on medium-value case)</i> | Project | Per unit |
| A. Residual revenues available for BOTH land and IZ | \$16,411,970 | \$164,120 |
| B. Required to cover inclusion net cost at 20% | \$8,488,381 | \$84,884 |
| C. Net residual after IZ = land value (A-B) | \$7,923,589 | \$79,236 |
| D. Actual land cost \$/sq. ft. (current sales) | \$120 | \$120 |
| E. Actual land cost (current sales) (D x total land sq. ft.) | \$10,650,000 | \$106,500 |
| Does project have capacity to absorb inclusionary zoning (is C>E)? | NO | NO |

When there is no inclusionary zoning requirement, any remaining residual surplus would generate additional profit. To the extent that this profit exceeds actual land costs, this “excess profit” will eventually be capitalized into land and potential developers will bid up to this value. So here the land would be bid up to \$16.4 million (\$185 per gross buildable sq. ft., even though recent sales suggest a more realistic current price is \$120 per buildable sq. ft.). This itself is a good reason to implement an inclusionary zoning policy — to reduce and minimize land speculation and inflating values.

Where the available residual surplus after land costs is less than the amount required to fully absorb the net cost of a 20% IZ requirement (as is case in Table 4), it may be possible to set a lower rate (below the base case of 20%). The analysis identifies potential alternate levels.

Where the available residual surplus after land costs is insufficient to fully cover the net cost of a 20% IZ requirement, it may be possible to utilize offsets, as available under the City of Toronto’s Open Door program. This could help “buy up” the inclusionary zoning rate to some established threshold level (e.g., 20%).

Conversely, where the available residual surplus after land costs exceeds the amount required to fully absorb the net cost of a 20% IZ requirement, it may be possible to increase the rate (above the base case of 20%).

Estimating value of offsets

The City already has a policy to waive and exempt affordable housing projects from a range of City fees and charges (Open Door program). Where there is

an insufficient surplus generated to cover the net IZ cost, these Open Door reductions can be applied to the portion of the development that is allocated as affordable. This could both reduce any negative impact on the development and, more importantly, raise the number of affordable units built.

The largest Open Door offsets are waiving development charges and charges for parkland dedication, and exempting from property tax. These values are estimated in the analysis. Some smaller additional offsets may also be available (e.g., permit fees).

Some offsets such as waiving fees and charges and waiving parkland dedication, can be directly applied against capital costs (and will flow through into the gross surplus available).

Where the offset involves exempting from property taxes, the amount of the annual property tax saving can be added to the NOI and then captured in the capitalized value of the affordable component. For the purpose of this analysis, a tax exemption on affordable units can be isolated and presented as a capital credit by applying the capitalized rate against the estimated annual tax amount.

It should be noted that the estimates of possible offsets draw on only a small set of City fees and charges. With the NBLC recommended larger allocation of soft costs (estimated at 60% of hard costs), it is likely that a larger amount of fee offsets could be achieved. Thus, the estimates used here are again very generous, resulting in quite conservative outcomes.

4. Exploring options and impacts across three case study areas

Following the methodology described above, the impact of IZ on the three case study areas is explored.

Review of the status quo — before an IZ requirement

Before determining the feasibility of inclusion, a status quo case is presented. This assumes no inclusionary zoning requirement. The main elements are shown in Table 5. With some small variations across the three areas due to differing parking ratios and costs, construction costs are relatively consistent (costs per unit are higher in the lowest value zone because the parking

requirement is much higher 0.9 vs. 0.6 and 0.3 due to the relative availability of transit). This increases cost to construct underground parking.

The market sales price substantially increases and generates much larger surplus in the higher price zone — which drives up land values and, potentially, capacity to absorb the cost of IZ units.

As shown, based on the surplus generated from development (before any IZ), the implicit land values (per gross buildable sq. ft.) would range from \$49 to almost \$400. Except in the low value area, these residual values are above prevailing recent sales values, as shown in Table 5. Depending on when the developer purchased the land, in the medium and especially high value areas there is considerable capacity to absorb inclusion, while still preserving a sound profit margin. Adding an IZ requirement will erode the high residual values and excess profit (implicit land value in Table 5).

| Table 5: Before implementing inclusion | | | |
|---|------------------------|-------------------------|-------------------------|
| Costs and values | Lower-cost zone | Medium-cost zone | Higher-cost zone |
| A. Construction costs units | \$199,688 | \$199,688 | \$221,850 |
| B. Construction costs parking | \$48,596 | \$32,397 | \$16,197 |
| C. Total construction | \$248,284 | \$232,085 | \$238,047 |
| D. Soft costs (at 60% of hard costs) | \$148,970 | \$139,251 | \$142,828 |
| E. Developer/builder profit (15% of gross sales) | \$77,844 | \$94,492 | \$126,875 |
| F. Total costs (C+D+E) | \$475,098 | \$465,828 | \$507,750 |
| Gross Revenue | | | |
| G. Market value (condo) | \$487,459 | \$599,950 | \$824,838 |
| H. Revenue parking sales | \$31,497 | \$29,998 | \$20,996 |
| I. Gross revenue = Market value (G+H) | \$518,956 | \$629,948 | \$845,834 |
| J. Surplus available for land and IZ (I-F) | \$43,858 | \$164,120 | \$338,084 |
| K. Implicit land value \$/buildable sq. ft. (J/total sq. ft.) | \$49 | \$185 | \$381 |
| L. Recent land values per buildable sq. ft. (current sales) | \$56 | \$120 | \$200 |

The next section briefly reviews the outcomes across the three value areas under two scenarios — developments under current zoning with 20% affordable units renting at 100% and then 60% of the city-wide AMR; and then the same scenarios assuming the property can be rezoned to a higher density.

4.1 Case A: Modest affordability (100% AMR)⁸

The first scenario, as shown in Table 6A, examines a 20% IZ requirement, with affordable units set at 100% of the City of Toronto 2018 AMR of \$1,380. This is not affordable for very low-income households, but is substantially below rents for newly completed rentals (which range from \$2,200-\$3,200/month across the three areas).

Construction costs per unit range between \$475,000 to \$508,000, while sales prices start at \$519,000 and reach over \$845,000 in the higher-value area, so the project generates substantial residual surplus (row D): from \$4.38 million in lower-value zones to over \$33 million in higher-value zones.

In the lower-value areas, after allocating some of this surplus to cover land costs, there is a negative residual (row F), and so no capacity to absorb an IZ requirement.

In the medium-value area there is a surplus (row F), but it is insufficient to achieve a 20% inclusion rate — it is only possible to reach 14% inclusion. This can however be raised to 17% if a range of offsets are contributed (via Open Door offset amounts) to the project (waiving development charges, permit and parkland fees, and exempting the IZ units from property taxes).

Only in the higher-value area can the project achieve and in fact exceed the 20% target threshold. In this area, with rents at 100% AMR, 25% inclusion is possible. However, it may be preferable to leave the threshold at 20% and push rents to a lower level (this is explored in Case B).

⁸ Tables presented here are at the project scale rather than on a per-unit basis. As this is a 100-unit project, per-unit values can be readily identified, except in the case of rows H and below which focus on the inclusionary aspects. The fractions of IZ units (base level 20%) and the sharing of absorption across the remaining (80%) market units complicate presenting the lower rows on a per-unit basis.

| Table 6A: Case A — Affordable at 100% AMR; 20% inclusion | | | |
|---|------------------------|-------------------------|-------------------------|
| | Lower-cost zone | Medium-cost zone | Higher-cost zone |
| A. Total units | 100 | 100 | 100 |
| B. Total construction (soft & hard cost & profit) | \$47,509,703 | \$46,582,781 | \$50,775,005 |
| C. Condo total sales revenue (incl. parking) | \$51,895,675 | \$62,994,750 | \$84,583,418 |
| D. Surplus available for land & IZ (C-B) | \$4,385,972 | \$16,411,970 | \$33,808,414 |
| Implicit land value with no IZ (\$/buildable sq. ft.) | \$49 | \$185 | \$381 |
| Recent land sales — value per buildable sq. ft. | \$56 | \$120 | \$200 |
| E. Required for land cost at current 2019 prices | \$4,970,000 | \$10,650,000 | \$17,748,000 |
| F. Net remaining to cover IZ requirement (D-E) | -\$584,028 | \$5,761,970 | \$16,060,414 |
| G. Target affordable inclusion rate (% of units) | 0.20 | 0.20 | 0.20 |
| Depth of affordability (as % AMR) | 100% | 100% | 100% |
| H. Forgone revenue per unit from allocating 20% to IZ | \$10,379,135 | \$12,598,950 | \$16,916,684 |
| I. Capitalized value of revenue from IZ units @100% AMR | \$4,114,889 | \$4,110,569 | \$4,045,319 |
| J. Net cost of allocating 20% to IZ units (H-I) | \$6,264,246 | \$8,488,381 | \$12,871,365 |
| Does net revenue cover net IZ costs at 20% (is F-J>0)? | NO | NO | YES |
| Potential IZ set aside rate | | | |
| K. What set aside rate is potentially feasible (Net revenue from units/net cost of 20% IZ units) (F/J x 20%) | -2% | 14% | 25% |
| L. Potential offsets available (waive City fees & charges) | \$1,554,192 | \$1,553,506 | \$1,543,047 |
| Maximum IZ with offsets (F+L)/J x 20% | 3% | 17% | 27% |

4.2 Case B: Deeper affordability at 60% AMR and 20% IZ rate

The second case examines a deeper level of affordability, set at 60% of Toronto's average rent. This will provide initial rents at \$828/month, which require a household income of \$33,100. While this is still high for those receiving social assistance or those working on minimum wage, it is more affordable than what 100% AMR units would provide.

Reducing the target affordable rent level to 60% AMR has implications for project viability — it reduces the capitalized value of the affordable units and thereby increases the net cost to absorb. This in turn lowers the number of units that can be absorbed, as demonstrated in Case B below.

As in Case A, it is only possible to achieve the target threshold of 20% in the high-value zones.

Again, a modest level of inclusion can be reached in the medium-value area at 11% or at 14% when utilizing offsets.

It is not feasible to achieve any inclusion in the lower-value zone — after applying potential offsets, only 2% of units could be set aside at affordable rents at 60% AMR.

| Table 6B: Case B — Affordable at 60% AMR; 20% inclusion | | | |
|--|------------------------|-------------------------|-------------------------|
| | Lower-cost zone | Medium-cost zone | Higher-cost zone |
| A. Total units | 100 | 100 | 100 |
| B. Total construction (soft & hard cost & profit) | \$47,509,703 | \$46,582,781 | \$50,775,005 |
| C. Condo total sales revenue (incl. parking) | \$51,895,675 | \$62,994,750 | \$84,583,418 |
| D. Surplus available for land & IZ (C-B) | \$4,385,972 | \$16,411,970 | \$33,808,414 |
| Implicit land value with no IZ (\$/buildable sq. ft.) | \$49 | \$185 | \$381 |
| Recent land sales — value per buildable sq. ft. | \$56 | \$120 | \$200 |
| E. Required for land cost at current 2019 prices | \$4,970,000 | \$10,650,000 | \$17,748,000 |
| F. Net remaining to cover IZ requirement (D-E) | -\$584,028 | \$5,761,970 | \$16,060,414 |
| G. Target affordable inclusion rate (% of units) | 0.20 | 0.20 | 0.20 |
| Depth of affordability (as % AMR) | 60% | 60% | 60% |
| H. Forgone revenue per unit from allocating 20% to IZ | \$10,379,135 | \$12,598,950 | \$16,916,684 |
| I. Capitalized value of revenue from IZ units @100% AMR | \$2,557,054 | \$2,552,734 | \$2,487,660 |
| J. Net unit cost of allocating 20% to IZ units - per IZ unit (H-I) | \$7,822,081 | \$10,046,216 | \$14,429,024 |
| Does net revenue cover net IZ costs at 20% (is F-J>0)? | NO | NO | YES |
| Potential IZ set aside rate | | | |
| K. What set aside rate is potentially feasible (Net revenue from units/net cost of 20% IZ units) (F/J x 20%) | -1% | 11% | 22% |
| L. Potential offsets available (waive City fees & charges) | \$1,306,497 | \$1,305,810 | \$1,295,379 |
| Maximum IZ with offsets (F+L)/J x 20% | 2% | 14% | 24% |

4.3 Case C: Rezone to higher density with IZ required as a condition, modest affordability

The previous two cases considered capacity to absorb with no change in current zoning. An important way to accommodate an inclusionary zoning requirement is to enhance the potential yield from development by increasing the allowable density through rezoning. Additional floor area and units create more sales and more profit. This can be shared to cover the costs of an IZ policy.

This case considers the effect of increasing the allowable density — increasing allowable density from 2.5 FSR to 3.5 FSR in the lower- and medium-value areas; and from 4.0 to 8.0 in the higher-value areas.

Such increased densities are already contemplated in many areas under the existing OP. As such, the excess values revealed in implicit land value estimates will already be anticipated by developers, so these latter scenarios may be more representative of current reality than the first two. But currently there is no requirement to share or contribute a community benefit (unless a specific Section 37 agreement is negotiated as part of the rezoning process).

| Table 6C: Case C —Affordable at 100% AMR; 20% inclusion; site rezoned to 3.5 in low- and mid-value areas and to 8.0 FSR in high-value areas | | | |
|--|------------------------|-------------------------|-------------------------|
| | Lower-cost zone | Medium-cost zone | Higher-cost zone |
| A. Total units | 140 | 140 | 200 |
| B. Total construction (soft & hard cost & profit) | \$66,513,585 | \$65,215,893 | \$101,550,009 |
| C. Condo total sales revenue (incl. parking) | \$72,653,945 | \$88,192,650 | \$169,166,837 |
| D. Surplus available for land & IZ (C-B) | \$6,140,360 | \$22,976,757 | \$67,616,827 |
| Implicit land value with no IZ (\$/ buildable sq. ft.) | \$49 | \$185 | \$381 |
| Recent land sales — value per buildable sq. ft. | \$56 | \$120 | \$200 |
| E. Required for land cost at current 2019 prices | \$4,970,000 | \$10,650,000 | \$17,748,000 |
| F. Net remaining to cover IZ requirement (D-E) | \$1,170,360 | \$12,326,757 | \$49,868,827 |
| G. Target affordable inclusion rate (% of units) | 0.20 | 0.20 | 0.20 |
| Depth of affordability (as % AMR) | 100% | 100% | 100% |
| H. Forgone revenue per unit from allocating 20% to IZ | \$14,530,789 | \$17,638,530 | \$33,833,367 |
| I. Capitalized value of revenue from IZ units @100% AMR | \$5,760,845 | \$5,754,797 | \$8,090,638 |
| J. Net cost of allocating 20% to IZ units (H-I) | \$8,769,944 | \$11,883,733 | \$25,742,729 |
| Does net revenue cover net IZ costs at 20% (is F-J>0)? | NO | YES | YES |
| Potential IZ set aside rate | | | |
| K. What set aside rate is potentially feasible (Net revenue from units/net cost of 20% IZ units) (F/J x 20%) | 3% | 21% | 39% |
| L. Potential offsets available (waive City fees & charges) | \$2,175,869 | \$2,174,908 | \$2,990,103 |
| Maximum IZ with offsets (F+L)/J x 20% | 8% | 24% | 41% |

4.4 Case D: Rezone to higher density with IZ required as a condition, deeper affordability

This final case similarly involves rezoning to higher densities and more units (3.5 FSR for a total of 140 units in lower- and medium-cost zones, 8.0 FSR and 200 units in high-cost zones). Here the rent levels in the inclusionary zoning units are set 60% AMR (\$828/month), with the result that the capitalized value of the affordable units (now 28 units and 40 units) is lower than the 100% AMR case (Case C). Consequently, fewer IZ units can be accommodated.

The result is that there is only marginal capacity to accommodate IZ costs in the low-cost area. In the medium-cost area, the capacity falls just below the threshold to only 18%; it can, however be brought back up to 20% by applying offset contributions.

In the higher-value zones, there continues to be excess capacity that could facilitate inclusion up to as much as 35% of the units.

| Table 6D: Case D — Affordable at 60% AMR; 20% inclusion; site rezoned to 3.5/8.0 FSR | | | |
|--|-----------------|------------------|------------------|
| | Lower-cost zone | Medium-cost zone | Higher-cost zone |
| A. Total units | 140 | 140 | 200 |
| B. Total construction (soft & hard cost & profit) | \$66,513,585 | \$65,215,893 | \$101,550,009 |
| C. Condo total sales revenue (incl. parking) | \$72,653,945 | \$88,192,650 | \$169,166,837 |
| D. Surplus available for land & IZ (C-B) | \$6,140,360 | \$22,976,757 | \$67,616,827 |
| Implicit land value with no IZ (\$/ buildable sq. ft.) | \$49 | \$185 | \$381 |
| Recent land sales — value per buildable sq. ft. | \$56 | \$120 | \$200 |
| E. Required for land cost at current 2019 prices | \$4,970,000 | \$10,650,000 | \$17,748,000 |
| F. Net remaining to cover IZ requirement (D-E) | \$1,170,360 | \$12,326,757 | \$49,868,827 |
| G. Target affordable inclusion rate (% of units) | 0.20 | 0.20 | 0.20 |
| Depth of affordability (as % AMR) | 60% | 60% | 60% |
| H. Forgone revenue per unit from allocating 20% to IZ | \$14,530,789 | \$17,638,530 | \$33,833,367 |
| I. Capitalized value of revenue from IZ units @100% AMR | \$3,579,876 | \$3,573,828 | \$4,975,319 |
| J. Net cost of allocating 20% to IZ units (H-I) | \$10,950,913 | \$14,064,702 | \$28,858,048 |
| Does net revenue cover net IZ costs at 20% (is F-J>0)? | NO | NO | YES |
| Potential IZ set aside rate | | | |
| K. What set aside rate is potentially feasible (Net revenue from units/net cost of 20% IZ units) (F/J x 20%) | 2% | 18% | 35% |
| L. Potential offsets available (waive City fees & charges) | \$1,829,095 | \$1,828,134 | \$2,494,767 |
| Maximum IZ with offsets (F+L)/J x 20% | 5% | 20% | 36% |

4.5 Challenges in implementing IZ in market rental projects

The preceding analysis has exclusively assumed a condominium development. From a practical perspective, there is great benefit in pursuing market rental developments, as a rental owner is better able to manage the rental units. And in the past three years rental construction has become more prominent in Toronto (as it has in other areas of the country).

However, the financial viability of rental development remains much lower than in condominiums.⁹ As a result, the capacity to absorb an IZ requirement is more constrained. A rental scenario is not included in the cases explored above, but it is briefly added here to highlight that there will be different challenges, and possibly a need for a different policy to apply against purpose-built rental developments.

For the rental case, revenues come via ongoing cash flows, rather than immediate sales receipts. Following the methodology used to quantify the cost of the IZ requirement, these future cash flows can be readily converted into a current value using market capitalization rates.

The rents assumed here are the prevailing levels for new rental construction (again extracted from data provided by NBLC) at \$2,250 to \$3,150. While these are well above the AMR level (of \$1,380), they fall below the rents common in the rapidly growing supply or “luxury rentals.” NOI is estimated by applying a typical operating expense ratio (.36) against gross rents.

This NOI is then capitalized (at the prevailing cap rate of 4%) to estimate to current value (row H in Table 7A). The capitalized values, based on net operating income, are far lower than in the condo case with the result that the residual surplus is also much smaller. The same construction cost is used as in the condo case. As shown in Table 7A, the revenues generated as a rental development generate a negative or minimal residual land value — so there is no capacity to apply an IZ in the case of current zoning.

⁹ The weak viability of rental versus condo is prevalent in many Canadian cities; it is however exacerbated in Toronto by the high number of high-value condominiums, which increase land prices and preclude rentals. In lower-value cities, such as Halifax, there is much less condo development and thus less distortion on land value.

| Table 7A — Market rental under scenario A: Base case current zoning | | | |
|---|---------------------|---------------------|---------------------|
| | Lower-cost zone | Medium-cost zone | Higher-cost zone |
| A. Market rent/month/unit | \$2,250 | \$2,850 | \$3,150 |
| B. Total units | 100 | 100 | 100 |
| C. Gross rent/yr. (A x12 x B) | \$2,700,000 | \$3,420,000 | \$3,780,000 |
| D. Parking revenue | \$91,800 | \$90,000 | \$63,000 |
| E. Gross revenue with 2% vacancy (C+D x 98%) | \$2,735,964 | \$3,439,800 | \$3,766,140 |
| F. Operating expenses (.36 OER) | \$984,947 | \$1,238,328 | \$1,355,810 |
| G. NOI (E-F) | \$1,751,017 | \$2,201,472 | \$2,410,330 |
| H. Lending value (at cap rate on market rent NOI) | \$43,775,424 | \$55,036,800 | \$60,258,240 |
| I. Gross cost to build (same \$/sq. ft. as condo) | \$45,027,516 | \$44,262,375 | \$48,395,075 |
| J. Surplus available for land and IZ (H-I) | -\$1,252,092 | \$10,774,425 | \$11,863,166 |
| K. Implicit residual land value | -\$12,521 | \$107,744 | \$118,632 |
| L. Actual land cost (current sales) | \$4,970,000 | \$10,650,000 | \$17,748,000 |
| M. Remainder to absorb IZ units | -\$4,982,521 | -\$10,542,256 | -\$17,629,368 |

Under a rezoning scenario, similar to Case C (rezone to 3.5 and 8.0 FSR), the higher density does generate a higher yield and can accommodate a very minimal level of inclusion in the medium- and higher-value areas (7% and 4%, respectively). The medium-value area is slightly higher because the differences in rental amounts do not offset higher building costs in higher-value zones.

| Table 7B: Market rental rezoned to higher densities (3.5 and 8.0 FSR) | | | |
|---|---------------------|---------------------|---------------------|
| | Lower-cost zone | Medium-cost zone | Higher-cost zone |
| A. Market rent/unit/month | \$2,250 | \$2,850 | \$3,150 |
| B. Total units | 140 | 140 | 200 |
| C. Gross rent/yr. (A x 12 months x B) | \$3,779,685 | \$4,787,601 | \$7,558,518 |
| D. Parking revenue | \$91,800 | \$90,000 | \$63,000 |
| E. Gross revenue with 2% vacancy (C + D x 98%) | \$3,794,055 | \$4,780,049 | \$7,469,088 |
| F. Operating expenses (.36 OER) | \$1,365,860 | \$1,720,818 | \$2,688,872 |
| G. NOI (E-F) | \$2,428,195 | \$3,059,231 | \$4,780,216 |
| H. Lending value (at cap rate on market rent NOI) | \$60,704,885 | \$76,480,784 | \$119,505,406 |
| I. Gross cost to build (same \$/sq. ft. as condo) | \$63,037,616 | \$61,966,706 | \$96,789,073 |
| J. Surplus available for land and IZ (H-I) | -\$2,332,731 | \$14,514,078 | \$22,716,333 |
| K. Actual land cost (current sales) | \$4,970,000 | \$10,650,000 | \$17,748,000 |
| L. Remainder to absorb IZ units (J-K) | -\$7,302,731 | \$3,864,078 | \$4,968,333 |
| M. What inclusion rate/level is feasible? | -17% | 7% | 4% |

This brief review suggests that it may not be feasible or desirable to impose an IZ requirement on new purpose-built rental projects renting at standard rental rates. An IZ requirement may act as a deterrent against building rental units, which at best are only marginally viable. Where high luxury rents are proposed (i.e. above \$3,500/month), it may be possible to impose an inclusionary requirement.

5. Summary insights

This analysis has sought to build on prior assessments by NBLC but using a different methodology. While NBLC used a sample of specific sites and sought to determine if residual values (after hard and soft costs) are sufficient to achieve a threshold density of 20% inclusion (at varying affordability levels), this assessment used a typical illustrative project of 100 units across three more general areas, reflecting lower-, medium- and higher-condo-price areas.

A set of assumptions (generally consistent with those used by NBLC) was used to estimate costs to build and potential sales proceeds. In all cases, very generous assumptions were used, such that the analysis errs on the low side of the potential number of units that can be generated by IZ without undue cost to the developer. In particular, a high assumption is used to estimate soft costs (at a ratio of 60% of hard costs) and parking requirements.

The methodology determined the potential yield in each area, and assessed whether this is sufficient to cover likely land costs (at current values) and the extent to which there is residual surplus to cover the cost of absorbing an IZ requirement.

The net cost of IZ is estimated by taking the difference between the gross revenue as a condominium sale, versus the capitalized valuation of the affordable rental units. Rather than a simple yes/no on the financial capacity to absorb the cost of a 20% IZ requirement, the current analysis also assesses if any level of inclusion can be accommodated, and at various levels of affordability from 60% to 100% of city-wide AMR.

Overall, the assessment corroborates the findings from NBLC — that a single consistent level of inclusionary zoning set at 20% is not viable across zones of different value. In some areas, that rate is far too high, while in others it is much lower than is achievable.

It also reveals that by applying offsets in the form of Open Door waivers of city fees and charges, it is possible to achieve at least a minimal level of inclusion in all areas.

Table 8 summarizes the results and shows both the residual surplus available to accommodate an IZ requirement and the average amount (across all units in the project) that is required. In the two base cases at current zoning (A and B), the project is 100 units in all three areas; in the rezoned cases (C and D) the density is increased to permit 140 units in the lower-medium zones (FSR 3.5) and 200 in the denser (FSR 8.0) higher-value zone.

| Table 8: Summary across three areas and four scenarios | | | |
|---|------------------------|-------------------------|-------------------------|
| Current zoning at 2.5/4.0 FSR | Lower-cost zone | Medium-cost zone | Higher-cost zone |
| Total units | 100 | 100 | 100 |
| Affordable units | 20 | 20 | 20 |
| Case A: Affordable rents at 100% AMR | | | |
| Surplus available for land and IZ | \$43,860 | \$164,120 | \$338,084 |
| Residual surplus required to absorb 20% | \$62,642 | \$84,884 | \$128,714 |
| Maximum potential inclusion % | -2% | 14% | 25% |
| Max with offsets | 3% | 17% | 27% |
| Case B: Affordable rents at 60% AMR | | | |
| Surplus available for land and IZ | \$43,860 | \$164,120 | \$338,084 |
| Residual surplus required to absorb 20% | \$78,221 | \$100,462 | \$144,290 |
| Maximum potential inclusion % | -1% | 11% | 22% |
| Max with offsets | 2% | 14% | 24% |
| Rezoning to 3.5/8.0 FSR | | | |
| Total units | 140 | 140 | 200 |
| Affordable units | 28 | 28 | 40 |
| Case C: Affordable rents at 100% AMR | | | |
| Surplus available for land and IZ | \$43,860 | \$164,120 | \$338,084 |
| Residual surplus required to absorb 20% | \$62,642 | \$84,884 | \$128,714 |
| Maximum potential inclusion % | 3% | 21% | 39% |
| Max with offsets | 8% | 24% | 41% |
| Case D: Affordable rents at 60% AMR | | | |
| Surplus available for land and IZ | \$43,860 | \$164,120 | \$338,084 |
| Residual surplus required to absorb 20% | \$78,221 | \$100,462 | \$144,290 |
| Maximum potential inclusion % | 2% | 18% | 35% |
| Max with offsets | 5% | 20% | 36% |

The derived residuals in the high-value areas are quite generous and reflect the fairly substantial rise in home prices across the GTA. While development costs have increased they have not risen as quickly as sales prices.

Higher prices and surplus in higher-value areas are already seen in much higher land costs. The differentials are narrower and thus capacity to absorb is lower in the medium-priced areas — but this will change if prices continue to inflate disproportionately to costs.

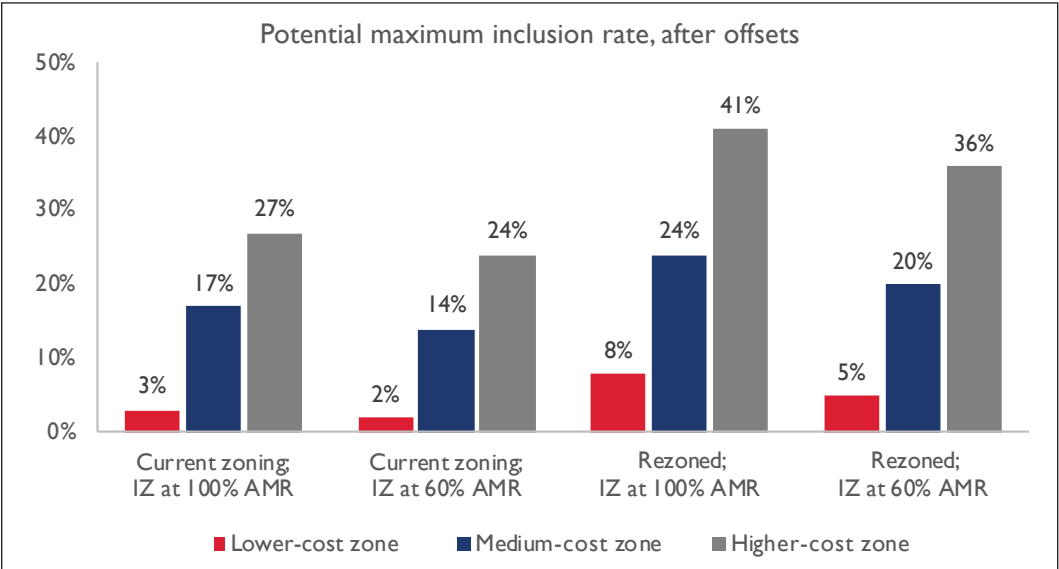
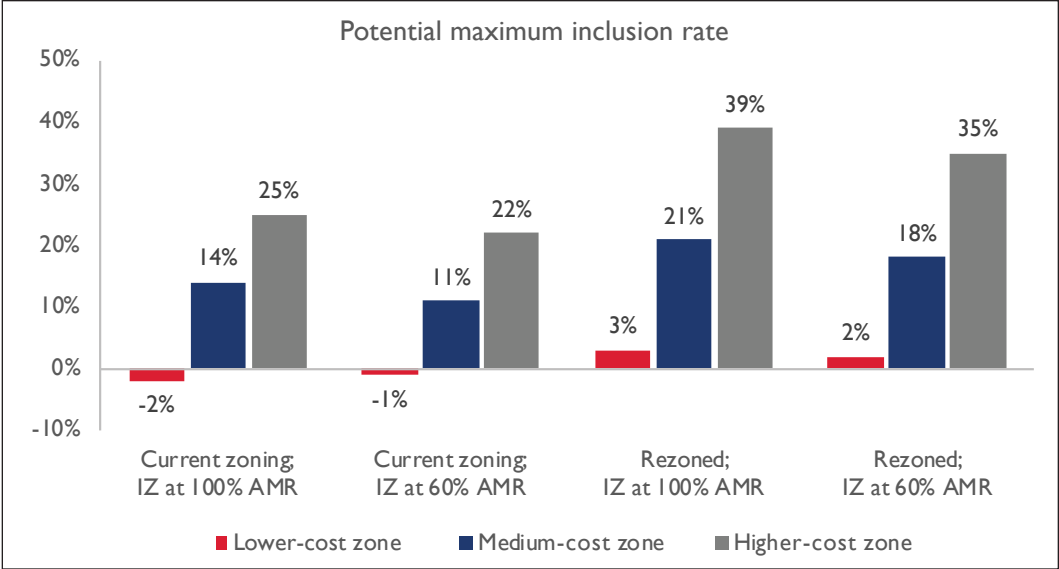
In the lower-value areas, the capacity to absorb is very limited. It is also notable that in recent years, there has been very little new development in these areas. This is reflected in a very low volume of apartment site property sales in both the low- and medium-value areas.

The analysis also confirms that when properties successfully rezone (here from 2.5 to 3.5 FSR in the lower-medium areas and from 4.0 to 8.0 FSR in the higher-cost areas), this enhances the residual surplus and the capacity to absorb IZ costs, as the public process of approving higher density increases potential yield.

Accordingly, it appears that implementing an IZ requirement on sites seeking rezoning to higher density creates greater capacity to absorb an IZ requirement. Furthermore, a policy linked to rezoning applications could potentially be implemented and phased in more quickly.

In areas where new transit lines and stations are proposed (including in current lower-value areas), there will be high potential for intensification and rezoning, through transit-oriented development. As potential routes and station siting are planned, the requirement for an IZ allocation should be immediately implemented.

The analysis focused mainly on properties being developed with condominiums. The situation will be quite different on rental sites, which have much lower capacity to absorb an inclusionary zoning option. There is a risk that applying inclusion on purpose-built rental sites, other than luxury rentals, may impose a disincentive and stall much needed rental construction. For this reason, sites proposing to create purpose-built rentals (at least those with rents below luxury levels) should be exempted from the policy.



5.1 Varying the IZ requirement by area

The analysis suggests that capacity to absorb will vary geographically, depending on local market conditions. It is greatest in the higher-value areas where the differential between cost and price is the greatest (although over time this becomes absorbed into higher land values).

Most new development activity is occurring in the higher-value areas and these areas have the capacity to fully absorb well above the target inclusionary zoning level of 20%, especially in cases involving rezoning to substantially

higher densities. The policy could be applied in this higher-value area, at a higher inclusion rate.

The analysis also reveals that it is possible to achieve a 20% inclusion in the medium-value areas, at least after applying the Open Door offsets, so these areas should also be included in the policy, either at the 10%-15% range they can sustain under IZ, or at 20% with the Open Door offsets.

Capacity to absorb is very constrained in lower-value areas, and it may be prudent to set the IZ rate for these areas at 0%, except on a voluntary basis, where developers can be incentivized using the Open Door offsets.

As part of an implementation process, it will be necessary to define and map the areas to which the policy should apply. Establishing a price zone based on new sales and/or tax assessment data can specify this.

Recently there has been limited new construction in the lower-medium areas, but this may change as developers seek new options, so the policy should anticipate and establish IZ parameters ahead of increased development interest. This can be an effective way to manage and mitigate the risk of inflating land costs negatively impacting potential affordability.

5.2 Depth of affordability

The analysis has examined only two levels of affordability — 60% and 100% of AMR (obviously intermediate levels such as 80% will fall in between in terms of potential to absorb inclusion). The evidence indicates that developments in the higher- and medium-value areas can support the creation of IZ units at deeper affordability, including units as low as 60% of AMR. Though efforts to do so rarely reach the 20% threshold considered by NBLC, these affordability levels can be achieved at lower rates.

These thresholds (60% and 100%) translate into rents of \$826 and \$1,380 per month, neither of which is affordable for very low-income households, such as those receiving social assistance. That said, it is not the role of housing policy to compensate for insufficient levels of welfare benefits. Separate measures, such as the proposed Canada Housing Benefit, are a better option to address issues of more severe affordability. However, building at moderate rents can address a supply shortage in the intermediate rental market and can create

a platform on which to stack rent supplements or housing benefit to achieve deeper affordability.

The practice in the 30-year-old US Low Income Housing Tax Credit (LIHTC) program has been both to stack rent supplements and to permit a choice in the number and depth of affordable units. So the IZ policy could permit a lower percentage of lower-rent units, e.g., 15% at 60% AMR or 25% at 100% AMR. Some calibration (of net cost to development) will be required to create a stronger incentive for lower-rent units.

The inclusionary requirement or capital grant can be an effective tool in achieving modest rents, but it is not alone a panacea for low-rent supply; a mix of program mechanisms and stacking of mechanisms is required to achieve deep affordability.

5.3 Duration of affordability

This analysis consistently used permanent affordability as the benchmark and this was not a barrier to creating economically viable IZ policies in most zones. An IZ policy should therefore seek to facilitate permanent affordability, rather than some time-limited requirement such as 20 years, as used in some policies. A limited period creates uncertainty for both residents and private owner and adds an administrative burden on the City to enforce (and future erosion of affordable supply).

It is recommended that all inclusionary zoning units be designated as permanent. While a rental developer-owner might hold and manage, it is assumed that in condominiums inclusionary zoning units would be sold to a non-profit owner operator. A non-profit would acquire these units based on 100% of the lending value, which is supported by the NOI generated at the assumed affordable rent threshold (so the non-profit would borrow to finance this transfer).

5.4 Potential phasing

The implementation of an inclusionary zoning policy will inevitably create some reaction and opposition from the development industry. However once fully implemented, as a cost of doing business the requirement will become

capitalized into costs, potentially with some downward pressure on land values. This is no different from school site or parkland dedications that were historically established in the planning and development process and are now fully accepted.

To allow the market to capitalize the cost of affordable inclusion, gradual phasing in will be required.

Subject to previously noted need for geographic variance (or inclusion zones), on sites with zoning in place, a new requirement for inclusion could be deferred to 2021 and phased in over a four-year period in 5% increments, starting in 2021.

On properties that seek a rezoning, the policy can be implemented on any rezoning application made after January 1, 2020. Here, a higher initial rate might be required (e.g., 10% initially rising by 5% annually to 20%).