nblc
Trusted advisors since 1976.

Memorandum

To:	City of Waterloo City of Kitchener City of Cambridge Region of Waterloo
From:	N. Barry Lyon Consultants Limited
Date:	September 28, 2023
RE:	Inclusionary Zoning – Supplementary Discussion Paper

1.0 Introduction

N. Barry Lyon Consultants Limited ('NBLC') has been retained collectively by the Cities of Waterloo, Kitchener, Cambridge and the Region of Waterloo ('the Partners') to provide a supplementary memorandum for discussion as it continues to consider and advance opportunities for the application of Inclusionary Zoning (IZ) policies throughout their municipalities. This discussion paper is intended to be complementary to NBLC's previous work on this project. It provides additional discussion regarding the potential classification of market strength across varying Protected Major Transit Station Areas (PMTSAs), and the application/ phasing of affordable housing set aside rates.

2.0 Market Area Categorization

While IZ policies can only be implemented at the area municipal level, the Partners have recognized the importance of adopting a consistent approach that can be applied region-wide. It is notable that the approach that has been presented to date would see a gradual increasing affordable housing set aside rates over time in order to avoid a shock to the market and encourage new housing supply overall. This approach is in line with NBLC's recommendations and is appropriate from a land economics perspective.

Stakeholders throughout the market will benefit from the clarity and consistency that this brings as the policy is applied. As part of this framework, three market area categories – "Prime", "Established", and "Emerging" – were considered, with each PMTSA being assigned one of these market area classifications. In the testing of IZ policy outcomes, each of the market strength classifications was assigned a set of market parameters that best reflected prevailing market conditions in Waterloo Region. Subject to market strength (among other built form considerations), testing demonstrated that the applicable set aside rates for an initial IZ policy should vary across these market categories in order to maintain development viability in initial years after the policy is implemented. The Partners have recommended initial set aside rates ranging from 0%, 1% or 2% through to 2027, with increases thereafter.

Factors considered in this initial categorization of PMTSA market strength included:

- The pace and volume of new high density apartment sales activity;
- Achievable sales pricing thresholds;
- The scale and volume of new high density residential development application activity; and,
- The pricing and volume of residential land acquisition activity.

The relative performance of new residential development activity related to the factors above was used to categorize PMTSAs into each of the three market area categories. As part of this supplementary review, the Partners have requested that recent market activity be considered to confirm and/or highlight any potential changes that could be considered in this classification. In this regard, we note the following:

- The new condominium apartment markets throughout Waterloo, Kitchener and Cambridge have continued their lackluster performance throughout 2023. Over the last eight months sales have slowed to about 415 units year-to-date down from more than 1,370 sales throughout the first three quarters of 2022. This, of course, is due to persistently high interest rates which has undermined sales activity from both end users and investors alike.
- While low rise product types have seen a decline in achievable pricing, pricing in condominium apartment formats appears to have remained relatively flat throughout the latter part of 2022 and into 2023. Notwithstanding this, some developers have held back supply and appear to be pausing sales activity until market strength returns.
- Despite the reduced sales activity, demand for housing in Ontario continues to build. Purchasers have been sidelined due to increased mortgage rates, and record immigration levels are adding to pent up demand. We expect that as lending rates and pricing stabilize, that buyers will return. TOD locations have proven, even in the current market, to be strong market draws. For example, at the Pickering GO Station, Centrecourt sold 95% of its 500-unit project over three days in September 2023.
- Rental market conditions continue to tighten, with vacancy rates in the Greater Golden Horseshoe returning to pre-pandemic lows, indicating significant unmet demand. Buyers, who are unable or unwilling to purchase homes, have only added to the demand for rental housing. The recent Federal announcement to waive the GST potion on the HST for new purpose-built rental housing should stimulate market interest in investing in rental housing going forward (moreover, there are recent signals that the Provincial government will follow suit).
- Persistently high interest rates, however, are likely to keep overall demand muted in the ownership market. In particular, the high costs of ownership have discouraged investors as market rents are

insufficient to support the investment costs and produce a reasonable return. This may have implications on development densities. High density projects that accommodate buildings with more than 300 units rely on a strong investor market to acquire a large portion of these units early in the pre-sale period. Without these investors, a project of this scale would encounter a prolonged sales program which can have significant impact on the financial viability of a development.

Overall, given the pace of change and volatility affecting the residential market, municipal policies that can potentially affect development viability, and the supply of new homes, should remain nimble and be updated at regular intervals. In this spirit, we have reviewed the previous classification of PMTSA areas for IZ testing purposes across the Waterloo, Kitchener and Cambridge market areas to consider whether any changes to PMTSA categorization appear to be warranted. An updated classification of submarket areas for testing purposes is shown in **Table 1**, where the following adjustments have been recommended:

- The Northfield PMTSA could be considered an 'established' submarket following relatively strong sales activity demonstrated in the area throughout recent development activity.
- The Uptown Waterloo PMTSAs (Waterloo Public Square, Willis Way and Allen stations) could be considered 'prime' submarkets. While there appears to have been some recent challenges affecting the the sales programs of some projects, there continues to be notable development interest as demonstrated through persistent development proposal activity and the area is very well positioned for growth and change from a market perspective.
- The Borden and Mill PMTSAs in Kitchener could be considered as established submarkets where a notable amount of recent land transaction and development application activity suggests that these submarkets are no longer being overlooked nor viewed as a pioneering development area.

Table 1

MTSA Market Areas

PMTSA	Municipality	Market Area
Conestoga	Waterloo	Established
Northfield	Waterloo	*Established*
Research & Technology Park	Waterloo	Established
University of Waterloo	Waterloo	Prime
Laurier	Waterloo	Prime
Waterloo Public Square / Willis Way	Waterloo	*Prime*
Allen	Waterloo	*Prime*
Grand River	Kitchener	Established
Central	Kitchener	Prime
Victoria Park / Kitchener City Hall	Kitchener	Prime
Queen / Frederick	Kitchener	Prime
Kitchener Market	Kitchener	Established
Borden	Kitchener	*Established*
Mill	Kitchener	*Established*
Blockline	Kitchener	Emerging
Fairway	Kitchener	Emerging
Sportsworld	Kitchener	Emerging

Table 1 Continued…

Preston	Cambridge	Emerging
Pinebush	Cambridge	Emerging
Cambridge Centre Mall	Cambridge	Emerging
Can-Amera	Cambridge	Emerging
Delta	Cambridge	Emerging
Main	Cambridge	Established
Downtown Cambridge	Cambridge	Established

3.0 Opportunities for Achieving Maximum Set Aside Rates

In November 2022, Provincial Bill 23 introduced proposed policy changes that, if implemented through regulation, provide additional clarity and structure regarding the design of IZ policies. Among other potential changes, the bill signalled the Province's intention to limit the total number of units that can be required to be affordable at 5% of units in a development and the introduction of a maximum period of affordability, at 25-years. This clarity is helpful for the private sector because it provides an understanding of the 'upper limit' for potential Inclusionary Zoning policies.

Developers typically acquire land on a speculative basis, based on their expectation of maximum approvable (and market supportable) built form. Given this forward-looking perspective, it remains important that IZ policy is designed and implemented in a phased approach that will allow for development to proceed in the near term whenever possible – this is particularly important in weaker 'emerging' market locations. At the same time, a policy framework that gives long term clarity to the market is beneficial because it allows the private sector to build potentially costly policies (like IZ) into land acquisition and project underwriting.

Within this context and amidst a challenging housing crisis, the Partners have been asked to consider instances where it may be possible to achieve the maximum set aside rate, or to accelerate the timeline for achieving the maximum 5% threshold. While the stie-specific nuance of every redevelopment project creates unique financial outcomes, we offer the following strategies that the Partners could pursue to establish higher initial set aside rates, and/ or to seek the maximum set aside rate at the conclusion of the policy's phase-in period.

3.1 Acknowledge unique policy contexts

Consider higher set aside rates in PMTSA areas where significant changes to planning entitlements have occurred, or, are anticipated.

In recommending an approach that acknowledges variation in market strength, our review of characteristics focused on market side dynamics. However, municipal and regional governments can have notable influence over land value and development viability through land use planning mechanisms. Moreover, the instance of significant policy change can add meaningful land value at the stroke of a pen. A prime example of this is when lands are shifted from *Employment* to *Mixed-Use* Official Plan policies.

Through discussions with the Partners, we understand that some of the employment lands in PMTSA areas throughout the region have been removed from the Region's Significant Employment Lands policy area through a recent Regional Official Plan Amendment and could potentially transition to include mixed use development permissions. What results is an enhanced opportunity for the exchange of community benefits (in this instance, affordable housing), that might not otherwise be sustainable if lands transacted at residential land values.

To contextualize the potential value uplift that these policy decisions can unlock, NBLC compiled land transaction data for high density residential sites and commercial land throughout Kitchener and Waterloo over the past 24 months. This desktop research indicates that the average land value for transacted vacant commercial lands has been in the order of $1.4 million per acre, whereas the value of high density residential land transactions has had an average in the order of $5 million per acre.[1]

A major shift in the land use policy context means that the range of development opportunities on affected sites becomes much broader, and more valuable. At present, this is particularly meaningful within the context of a challenging post-pandemic environment office market where increased remote working patterns threaten to reduce office space requirements permanently.

It is recommended that staff review these potential policy changes in detail to consider whether meaningful changes to lands within PMTSAs warrant a different application of IZ policy parameters. There may be geographic areas where policy changes unlock opportunities to apply the maximum 5% set aside rate in the near term.

3.2 Plan for positive market evolution

Previous proforma testing indicates that a uniform IZ set aside rate is unlikely to be achievable at present across all of the PMTSAs in Waterloo, Kitchener and Cambridge. Moreover, there has been a significant amount of volatility affecting the viability of new residential projects in the market of late. However, fundamental economic factors suggest that the long-term outlook for residential demand remains positive overall. While the pace of market evolution is uncertain, it is appropriate in our view to plan for market strength to return over time.

With this perspective and still reserving flexibility to adjust policy parameters in the future (two-year intervals have been proposed in draft policy direction), **the cities of Waterloo, Kitchener, and Cambridge should signal an intent to seek the full 5% set aside rate at the conclusion of a phase-in timeline across all PMTSAs.**

Should economic challenges persist over the long term, policies could be modified to maintain a 'low and slow' approach to phase-in while maintaining viable development outcomes wherever possible. Potential policy adjustments following biennial review could include an extension to the length of the phase-in period, or adjustments to the set aside rates themselves, if warranted.

[1] Land values are a weighted average based on land transaction data compiled from Altus Data Solutions and Costar Group for sites between 0.5 and 10.0 acres in size.

The Partners have taken positive and appropriate steps in clearly signaling their intentions for an emerging policy in order to ensure that future speculative land market activity can begin to adjust to new cost considerations. We maintain that IZ should be viewed as a forward-looking policy that will be in-force and adjusted over the long term. The policy has the potential to create thousands of affordable units over time. However, this requires a measured approach and recognition that the policy tool must be well aligned with market and economic reality.

Markets can – and do – evolve quickly. So, rather than to signal that weaker market locations, where speculative land purchasing has yet to ramp up, are not desirable locations to implement IZ policies to the full extent available, it remains appropriate to plan for viable TOD and an exchange of community benefits in the future. The challenge for the Partners is in designing a policy and program framework for IZ that will not adversely delay the market's maturation process in these emerging locations. While absolute precision is impossible, sensitive early implementation (as has been proposed by the Partners) will in fact condition the development community around future expectations, making IZ predictable as part of future development.

The Partners should continue monitoring market conditions after the introduction of IZ because there is likely to be a lag – perhaps over several years – between the timing of policy introduction and when impacts (positive or negative) are realized throughout the region. The Partners should continue to pursue a policy framework that can react quickly to changes in market conditions and cost factors as required; this could include upswings in market strength as economic conditions stabilize.

3.3 Incentivise desired outcomes in the interim

A strategy that the Partners could employ in order to accelerate or increase initial affordable housing set aside rates could be to offer financial incentives to new development projects in the near term. If these incentives were calibrated to fully offset the impact that the delivery of affordable units creates, the Partners could seek higher set aside rates than would otherwise be sustainable without additional incentives.

We note and acknowledge that recent provincial policy revisions do include certain fee and charge exemptions for affordable units and that the Partners' policy framework includes a removal of parking requirements for affordable units. However, while these reductions are beneficial from the private sector's perspective, the value of these incentives does not fully offset the impact of delivering affordable units.

Incentive programming could include:

- Additional density above the current approved zoning to offset the costs of an affordable housing component (i.e., a voluntary approach);
- The provision of financial incentives to the project to offset some of the costs of the affordable housing contribution; or,

- A combination of the previous two approaches above.

In market locations where residential demand is weaker, density will have less value. In fact, there are instances where added density would detract from the viability of a project by adding costs, time and risk. Therefore, a policy that exchanges density for housing will be less viable outside high demand PMTSAs where financial incentives will be more effective as an interim solution. However, as the market evolves and demand improves, the need for these incentive tools diminishes because development density becomes more powerful as an incentive.

The calibration and monitoring of incentive programming would need to be managed carefully to ensure that the value of the combined incentives is meaningful as an offsetting measure. In our view, financial incentives would be best delivered over a limited timeframe and reviewed regularly in order to ensure that this programming could be reduced or withdrawn as submarkets mature.