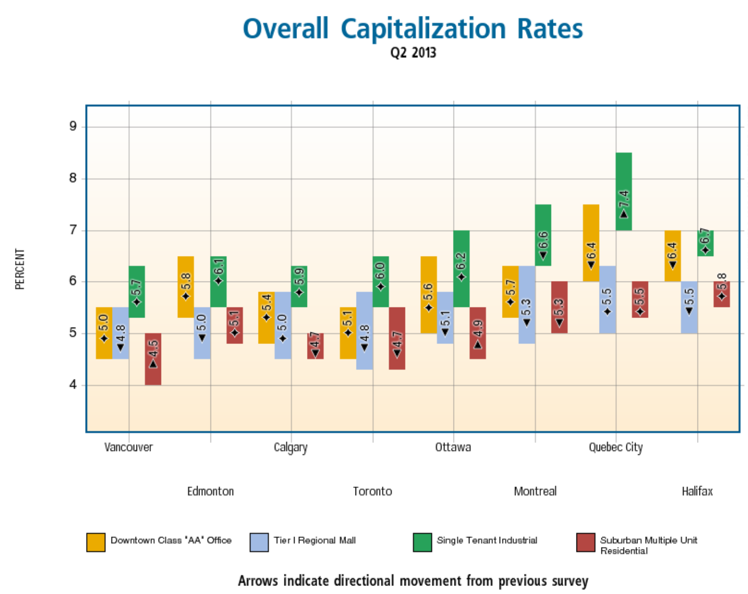
Cap Rate Compression Continues after a Short Pause

Altus InSite Q2 2013 Investment Trends Survey Summary Outlook

After a brief lull, the first since Q3 2009, cap rates continued their slow descent to new record levels this quarter, according to the latest Altus InSite *Investment Trends Survey* results. At 5.62% last quarter, the average OCR across the 8 markets and 4 major asset types has compressed by a few points and now stands at 5.55%. While the overall average cap rate has compressed by a mere 7 points during the last quarter, results differ substantially from one asset class to another, although all basis point variations remain in the single digit range.

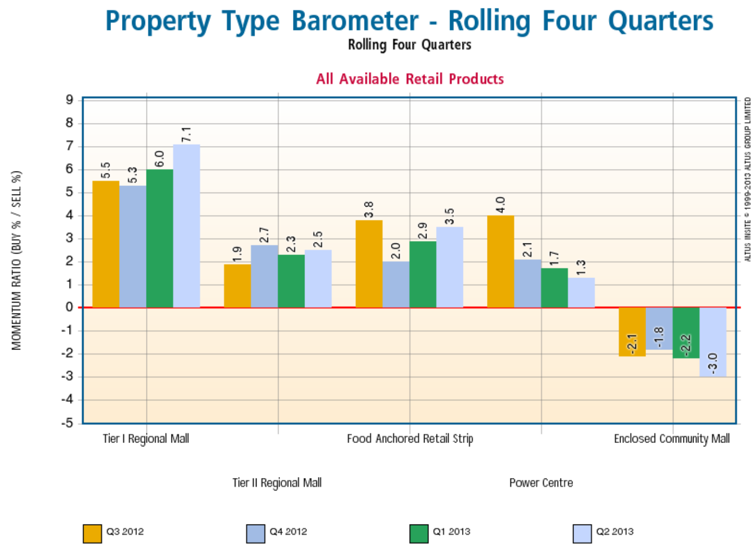
Suburban Multiple Unit Residential, the most aggressively priced asset class, has posted stable OCRs at an average 5.06% for 3 consecutive quarters. The priciest market, Vancouver (average price: $179,200/unit), has seen its average OCR rise from 4.1% last quarter to 4.5% this quarter, closing the gap between the average OCR in Toronto and Calgary, which now stand at a record low 4.7%, after a 20-point compression in each market over the same period. Other markets recorded very little or no change since Q1 2013. While this could be a sign of values stabilising, 38% of survey respondents expect further increases in value for this asset class in the next 12 months.



Single Tenant Industrial is also showing signs of stability, with only a 10-point compression since last quarter, moving from an 8-city average of 6.34% to this quarter's 6.33%. Average OCRs in Quebec City and Edmonton registered a small 10 point increase and now stand at 7.4% and 6.1% respectively. Inversely, Montreal (6.6%) and Calgary (5.9%) both recorded a 10 point compression since Q1 2013, while other markets remained stable over the same period. Total year-over-year compression for this asset class was a modest 26 points, with only 27% of survey respondents expecting this asset class to increase in value in the next 12 months.

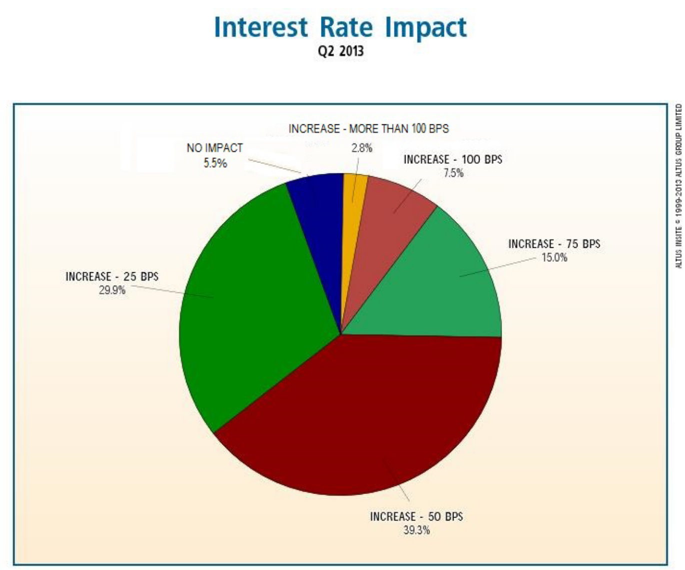
It is difficult to establish a clear pattern on the office side. After a hardly noticeable 2-point increase in OCR between Q4 2012 (5.74%) and Q1 2013 (5.76%), the 8-city average OCR for Downtown Class AA Office dropped to 5.68% this quarter. This is in contrast to most other markets, with the exception of Ottawa (10-point increase) recording a compression in cap rates, with Vancouver, Toronto and Montreal compressing by a modest 10 points since last quarter. Curiously, Quebec City and Halifax, which recorded cap rate increases last quarter, are showing the largest compression for this asset class this quarter, at 30 points and 20 points respectively. Average cap rates in Edmonton and Calgary have not changed for three quarters in a row.

In this context of modest compressions, Tier 1 Regional Mall stands out with an impressive 17-point compression between Q1 2013 (5.30%) and Q2 2013 (5.13%). The average OCR has compressed by a total of 44 points since Q2 of last year – the most significant change across all the asset classes covered. Tier 1 Regional is by far the most popular asset class on the Altus InSite *Investor Preference Barometer*, and its popularity is gaining momentum.



Still All about Interest Rates

If current returns on real estate investments seem low, the real estate premium has never been higher. As long as interest rates remain low, the case for real estate investment is sound. However, interest rates will eventually rise and some investors are expecting an impact on values. When asked about the impact of a 1.0% increase in interest rates on overall capitalization rates, more than half of the Altus InSite Investment Trends Survey Respondents estimate a hike of at least 50 basis points. Fears of eventually higher interest rates have already affected the REIT market where rates of return expectations have increased by about 60 basis points since last month.



Interest rate policies are definitely a key market indicator on real estate investors' radar screen. But while future rise in interest rates is inevitable, investors have grown accustomed to seeing it delayed and postponed again and again. The bank of Canada and its US counterpart have communicated the need to bring interest rates back to 'normal' levels. However, lower than expected GDP Growth in both countries makes this move risky and supports pushing back a bit more. Rate increases may be coming, but when they do, they will be small and incremental.

Every quarter, senior Altus Group professionals reach out to over 300 investors, managers, owners, lenders, analysts and other market stakeholders to survey their opinion on value trends and perspectives. Conducted with the same benchmark properties for over 10 years, the survey provides valuable insights on valuation parameters for 32 asset classes in Canada's 8 largest markets. For more detailed survey results, please contact support@altusinsite.com.