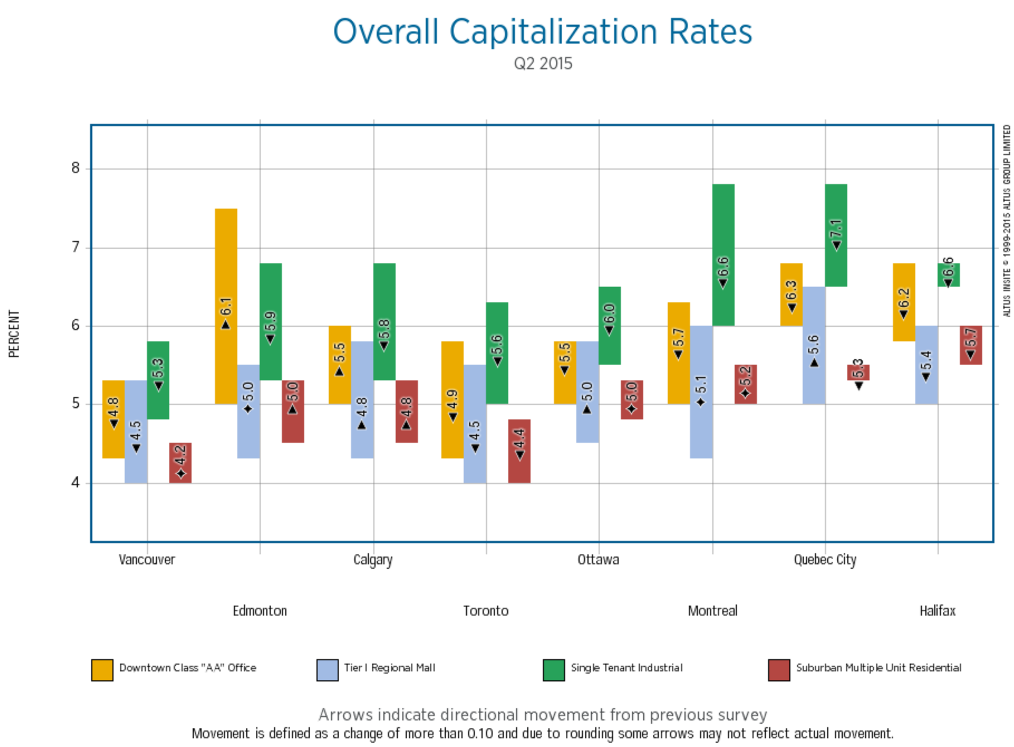
Excess Capital Continues to Seek Refuge in Real Estate

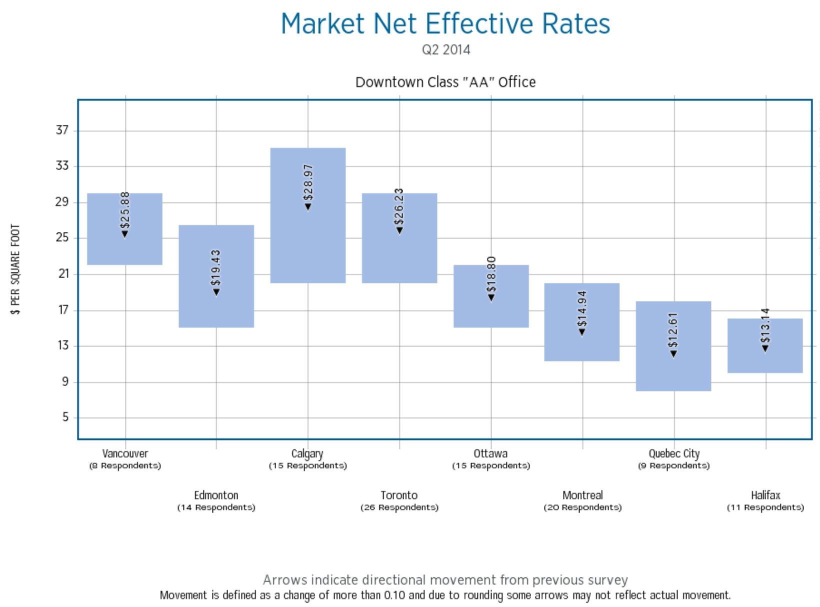
Altus InSite Q2 2015 Investment Trends Survey Summary Outlook

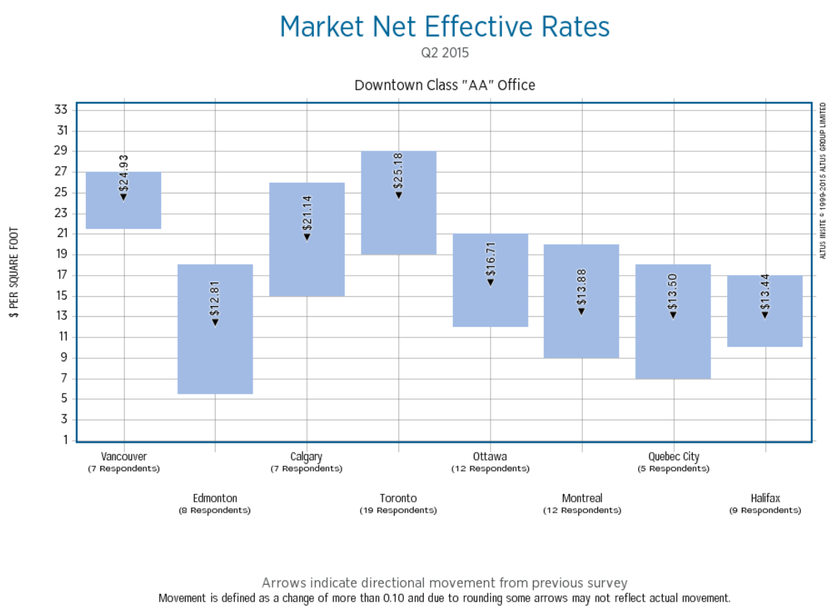
Many thought cap rates could not go any lower. Altus InSite's Q2 2015 Investment Trends Survey results confirm investors' ongoing appetite for commercial real estate. Results indicate that the average Overall Cap Rate (OCR) for the survey's 4 benchmark asset classes in Canada's 8 major cities reached a record low 5.42% in Q2 2015, down 6 points since Q1 2015 and the lowest return recorded in over 10 years of the survey. Single Tenant Industrial compressed the most (15 basis points) this quarter, followed by Downtown Class AA Office (7 points). Cap rates for Tier 1 Regional Mall and Multiple Unit Residential have remained stable. The national average OCR for these two asset classes has been hovering between 4.95% and 5.05% for the last 6 quarters.

The national average OCR for Tier 1 Regional Mall, standing at 4.98%, has not moved a single point since Q1 2015 and is now in its third quarter below the 5.0% mark. The eight-city average OCR for Multiple Unit Residential, at 4.95%, is also stable and unchanged from Q2 2014. Over the last quarter, benchmark multiple unit residential markets either remained stable or compressed slightly with the exception of Edmonton and Calgary, which each registered a 10-point increase. Seen by many investors as the asset class offering the most potential for upside, the industrial market registered the most significant cap rate compression, with a 23-basis-point change over the last 12 months, 15 points of that in the last quarter. Absorption has been positive for most industrial markets across the country. Vacancy for the best products – right ceiling heights, location and age – is tightening, spurring new construction of both spec and built-to-suit, with no excess supply in sight. Investors seem to factor in the lower Canadian currency and expanding economic growth in the US as favorable to this asset class' anticipated performance.



In the Downtown Class AA Office Market, the national average stood at 5.63%, down seven points since Q1 but basically back to last year's average (5.64%). The average OCR increased by 10 points this quarter for both Calgary and Edmonton, while it compressed slightly in other markets. The average Cap Rate for Edmonton's Downtown Class AA market increased by 50 basis points (from 5.6% to 6.1%) between Q2 2014 and Q2 2015. In addition to the impact of lower oil prices, over one million square feet of Class A space is currently under construction in Downtown Edmonton (EAD Office Tower, Stantec Building and Kelly Ramsey Building), representing about 10% of the existing inventory. In Greater Calgary, no less than 27 projects totaling 5.6 million square feet are currently under construction, including six Downtown Class AA projects (3.8 million sq. ft.). Year over year absorption in Calgary's downtown market was a loss of 1.35 million square feet as of Q2 2015.





While much of our attention is on the Alberta markets, watching for additional impacts of oil prices and the surprising orange wave, the situation is not a lot rosier elsewhere in the country. Excess capital seeking real estate investment opportunities continue to foster more development, and after three years of accumulating compelling new projects, backfill in existing buildings is now a real factor. In the face of intense competition and to cover the costs of supporting vacant space, some owners have started to offer more aggressive inducements and leasing incentives, resulting in declining NERs. Compared to the Q2 2014 survey results, this quarter's average NERs declined in all Downtown Class AA Office markets with the exception of Quebec City (+7%) and Halifax (+2%). The most significant declines were seen in Edmonton (-34%) and Calgary (-27%), followed by Ottawa (-11%), Montreal (-7%), Toronto (-4%) and Vancouver (-4%). It is important to note that these numbers are based on investors' opinion for a sample of benchmark assets and not the results of actual contractual rents averages. That said, these trends do reveal current investor sentiments.

The growing disconnect between prices that investors are willing to pay for the best assets and the underlying market conditions supporting these same assets' performance and potential for upside seems to have stretched beyond reasonable assumptions. But what other investment alternatives do investors have? Seasoned real estate investors with pockets deep enough to hold through cycles seem confident they can win at that game. And, contrary to the volatile stock market which is constantly reacting to external and uncontrollable events (Grexit, Oil prices, what's next?), owning real estate provides a different level of control and comfort. Competitive advantage can be established and sustained through superior service to tenants, customers, investors and other stakeholders, tight operations, strategic reinvestment and creative upgrades and through positioning/repositioning/repurposing of assets.

As long as real estate financing remains abundant and cheap, and as long as other safe investment alternatives offer meagre performance (Canada 10-year bond rates are still below 2.0%), we expect demand for real estate investment to remain strong. Even the impact of an increase in interest rates does not seem to worry our survey respondents. When asked about the impact a 1.0% increase in interest rates would have on cap rates, 35% of respondents expect an increase of 25 basis-points and 5% expect no impact at all. Interestingly, while 20% of respondents expected an increase of 75 points or more in Q2 2014, this proportion is down to 15% one year later.

Now postponed to mid-September, the U.S. Federal Reserve's interest rate hike is expected to be modest and could still be postponed. On this side of the border, multiple scenarios of further interest rate cuts offer the promise of low cost capital for the near future.

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.