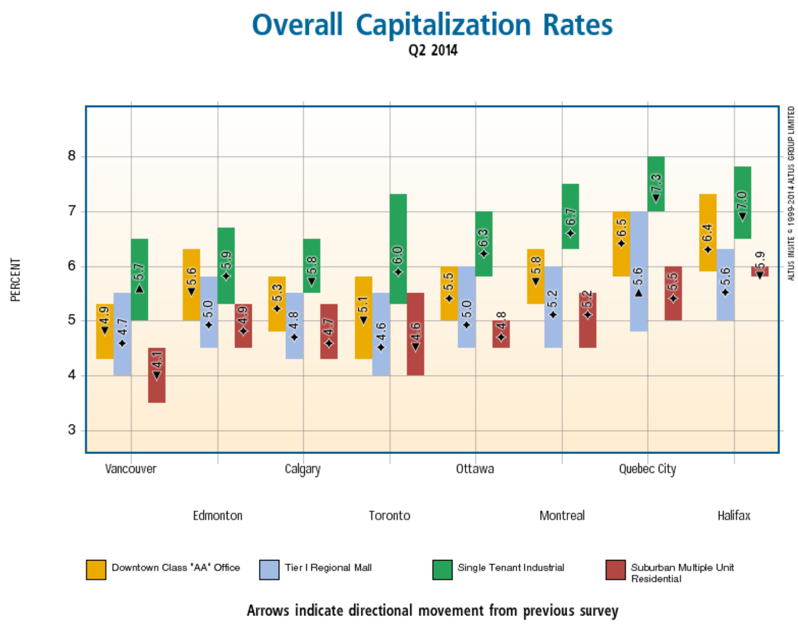
Cap Rates for Commercial Real Estate Continue to Plateau in Canada

Over the past two years, results of the Altus InSite Quarterly Investment Trends Survey pointed to cap rates levelling off for all asset classes. With the exception of the Q3 2013 results (survey conducted in August 2013), the ITS 8-city, 4-asset-class average OCRs hovered between 5.53 and 5.55 only to reach a new record-low 5.50 this quarter. However, while cap rates have leveled off, there is no sign of increase in sight.

While further reductions might seem to contradict the direction the market was taking in the fall, in reality, the cap rates of recent transactions in Canada's major markets since the beginning of the year also show no upward trend. Moreover, in the Q2 2014 Korpacz survey results, the equivalent of Altus InSite's ITS for the US market, the national average for the most similar benchmark asset classes also revealed slight cap rate compression of 9 points between Q1 2014 and Q2 2014. This is a strong signal that commercial real estate investment remains in favour.

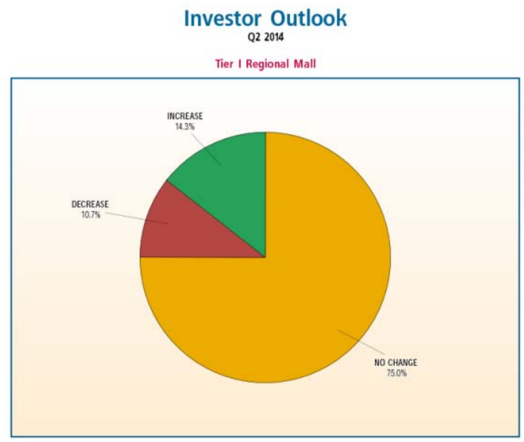


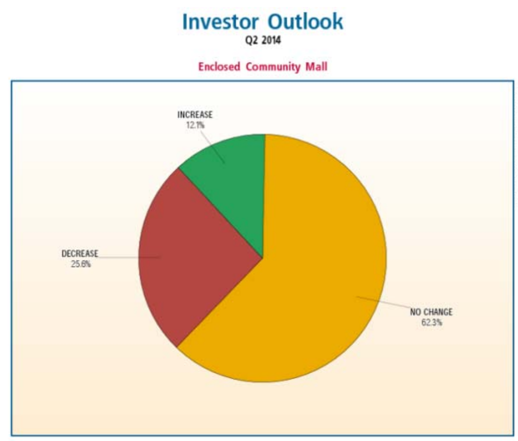
The renewed decline in global long-term bond yields is not a stranger to this. The 10-year Government of Canada bond rate has dropped by 50 points since December 2013 and, at 2.22% in May 2014, is at its lowest level since May 2013. On the commercial real estate side, the combination of abundant capital, low interest rates and few quality assets available for sale continues to fuel competition for the best real estate investment opportunities. REITs have become more active on the acquisition front and the stock market is showing positive momentum and now compares advantageously with real estate yields. Improvements in economic growth, despite turmoil in Ukraine and Iraq, seem to exert a positive effect on all investment alternatives, including real estate which is still perceived as a relatively safer option.

More Markets Now Below the 5% Threshold

Suburban Multiple-Unit Residential, one of the most sought after asset classes, has passed a new threshold with the 8-city-average cap rate now below the 5% mark (at 4.96%). However, this average conceals significant regional variances, from 4.1% in Vancouver to 5.9% in Halifax. At 5.64%, the national average OCR for Downtown Class AA Office is also at a record-low, with regional variances ranging from 4.9% in Vancouver to 6.5% in Québec City. For Tier 1 Regional Malls, average OCRs in Vancouver, Calgary and Toronto have remained stable and below the 5% mark for the last three consecutive quarters. Single-Tenant Industrial, offering the highest OCRs of all four benchmark asset classes, has remained stable between 6.33% and 6.36% for more than a year now (when excluding the unusual spike in Q3 2013).

While these aggressive yield expectations seem to leave little room for more value increases via further yield compression, the ITS Investor Outlook results show that some optimistic investors (12% to 14%) continue to think there is potential for growth. It is interesting to compare the expectations for the most preferred asset class on the Altus InSite Survey Barometer, Tier 1 Regional Mall (4.8 buyers per seller) to one of the least favoured asset class, Enclosed Community Mall (2.1 sellers per buyer). Notwithstanding this contrasting buyer/seller preference for these two asset classes, as for almost all other asset classes covered in the survey, the majority of respondents expect values to remain stable over the next 12 months.





In the context of abundant capital seeking yield, declining Government of Canada Bond rates and a future increase in interest rates that is expected by most economists to be modest and postponed to mid-2015, there are few immediate clouds in sight for commercial real estate investment. Even an expected increase in interest rates does not seem to trouble investors too much: According to the ITS survey, 75% of respondents nationwide expect that a 1% increase in interest rates (which is higher than what is expected by most economists) would push cap rates up by 50 points or less.

However there are pockets of both opportunity and pain that will ensure the market remains interesting and active. The evolving impact of the internet on power centres and other retail formats, the decline in office building occupier demand for older assets including some former top-of-market buildings, the increases in electricity costs and the decline in competitiveness of Ontario's manufacturing sector are but three examples of potential drivers of change within specific asset classes. While the averages may not be moving dramatically, that does not mean that specific buildings are both enjoying significant gains and material declines in net income and therefore value. While the averages are important, it is the building-specific and occupier-specific details that truly matter the most.