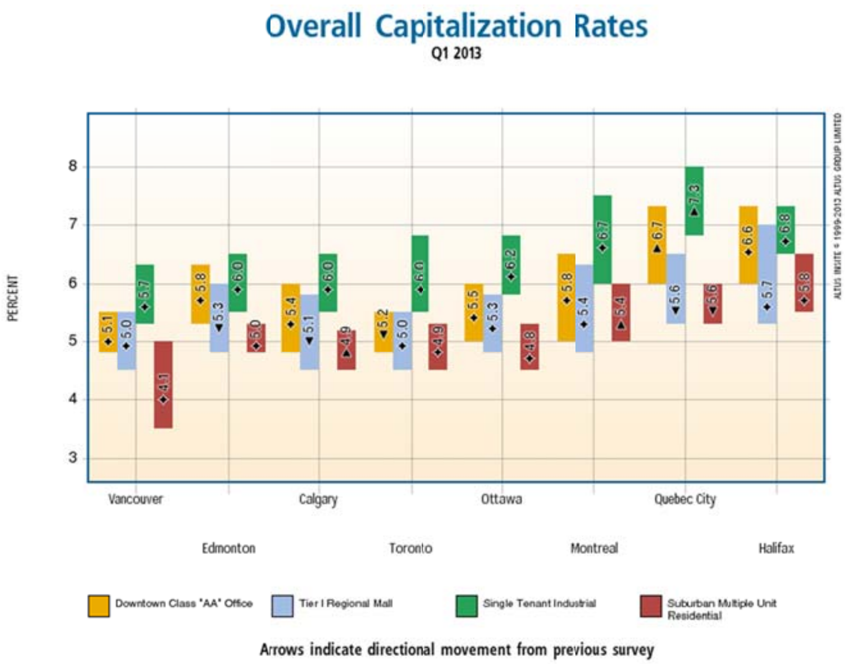
Cap Rates Leveling Off for the First Time in Over Three Years

Q1 2013 Investment Trends Survey Summary Outlook

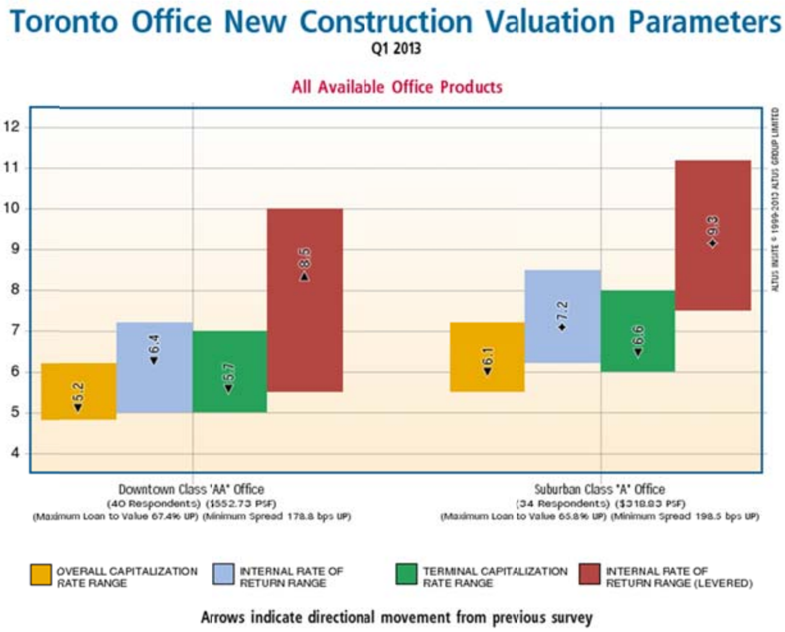
Surprise, or not…For the first time since Q3 2009, Altus InSite Investment Trends Survey results show that the eight-city average for cap rates has remained stable, at 5.6% for two consecutive quarters, ending a 14 consecutive quarters of decline. It is not clear if this is just a pause as investors feel increasingly uncomfortable with rising prices for all classes of commercial real estate, or a more permanent market shift. Such a halt should not be seen as a loss of appetite for real estate investors who are still under tremendous pressure to place capital in a market short of investment opportunities. But this is certainly a reminder that real estate prices are cyclical and cannot keep rising indefinitely.

The most significant compression across all four asset classes included in the survey was a modest five points for Tier 1 Regional Mall, which has seen its eight-city average drop from 5.35% to 5.30%. All eight markets surveyed registered either no changes or little compression and this asset class remains in favour, as shown on the Property Type Barometer for this quarter. In fact, over the last 16 quarters, Tier 1 Regional Mall ranked as the most popular product type on the barometer for all but three quarters. The Single Tenant Industrial market has followed a similar trend, with an eight-city average OCR of 6.34% this quarter, compared to 6.35% in Q4 2012. It should be noted, however, that the cap rate increased in Quebec City (20 points) and Halifax (10 points) since last quarter. All other markets saw compression, with the exception of Montreal and Calgary, which recorded no changes.



Suburban Multiple Unit Residential, the most aggressively priced asset class, has seen OCR compressions stabilising at an average 5.06% for two consecutive quarters. The markets at opposite ends of the country are also at opposite ends of the scale of results, with Halifax being the highest at 5.8% and Vancouver the lowest at 4.1%, and both saw no change from Q4 2012. Calgary and Montreal both moved up 10 points, but that uptick was offset by a 10 point decrease in both Quebec City and Toronto. For the Downtown Class AA Office market, the survey result point to mixed signals. The average OCR moved up in Halifax (10 points) and Quebec City (20 points), while all other markets have remained stable since the previous survey. The national cap rate average would have remained the same if it were not for the Halifax and Quebec City increases, which brought the eight-city average up from 5.74% in Q4 2012 to 5.76% in Q1 2013.

In the context of high priced high quality assets, many well capitalized investors are turning to new development in an attempt to get more return on their investments and add quality assets to their existing portfolio. Given the readily available and affordable financing in certain cases, it is now just as expensive to buy as to build top quality assets. As we can see from this quarter's opinions on valuation parameters for new construction of Class A office in Toronto, survey participants estimate price per square foot for Downtown Class AA office space at almost $553/sq. ft. and approximately $320/sq. ft. for newly built Class A space in the suburbs.



Interestingly, the Q1 2013 survey results show that the price for Downtown Class AA office space in Toronto (Benchmark Property for this asset class is Freehold Exchange Tower) is estimated by respondents as approximately $550/sq. ft.

The past year has been an interesting one, sending mixed signals from one quarter to the next. Total compression between Q1 2012 and Q1 2013 was only 30 points for the eight-city average for Downtown Class AA Office and Tier 1 Regional Mall, 38 points for Single Tenant Industrial and 44 points for Suburban Multiple Unit Residential. As we look back at 2012 and compare that to the results for Q1 2013, it looks like the market is approaching a plateau. But it could also be just a pause and we are not ready to confirm a definite shift in values.

The amount of capital seeking yields on the commercial real estate market, in the absence of better alternatives, and investors' appetite for revenue producing properties is still overwhelming. In this context of low interest rates and abundant capital and financing, transactions that might seem extraordinarily expensive still make sense in terms of real estate premiums, especially for acquiring a property that fits a specific portfolio mix or diversification strategy. The next survey will provide a better indication of value trends but one thing is becoming clear: the end of this cycle is getting closer.

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.