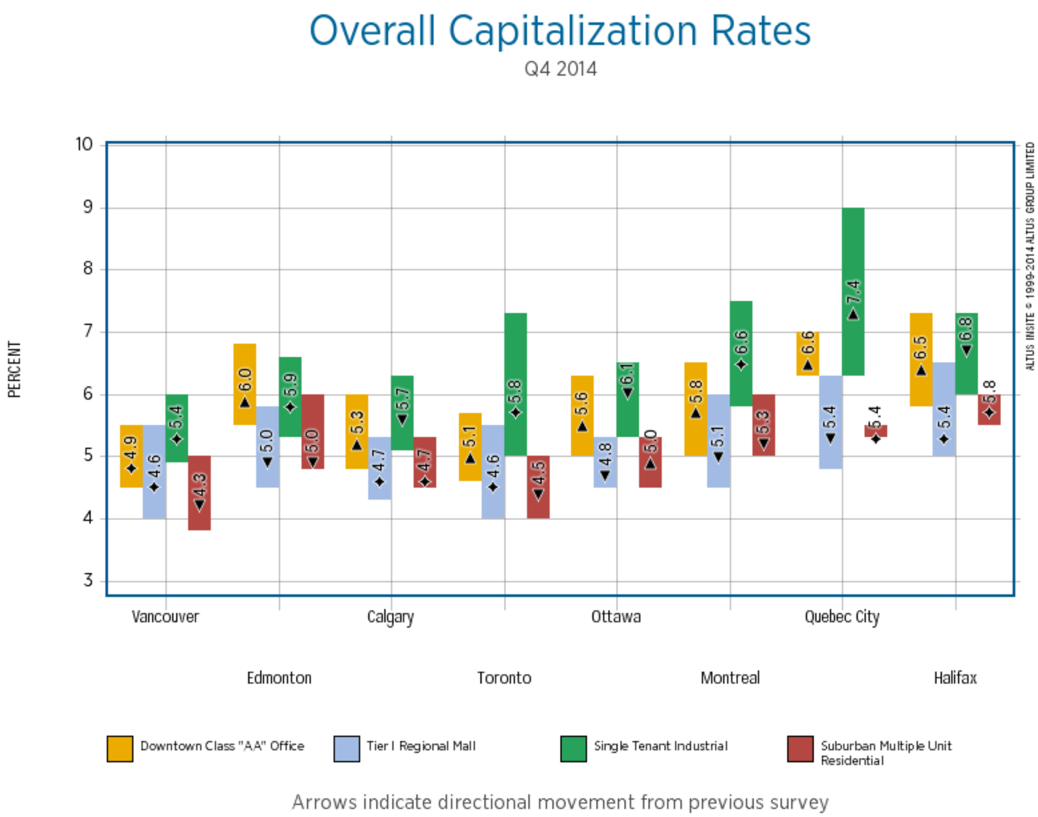
Cap Rate Stability Masks Shifts in Dynamics and Drivers

The most recent Altus InSite Investment Trends Survey results for Q4 2014 extend the theme of prior results and one full year has now passed without significant shifts, either upwards or downwards, in cap rates expectations. In fact, at 5.47% in Q4 2014, the national Cap Rate (OCR) average for the four benchmark asset classes in Canada's eight major cities is exactly the same as it was in Q3 2014 and only 6-basis-points lower than in Q4 2013. While this pattern applies to all benchmark asset classes, slight differences among cities can provide a hint as to how the market may behave in 2015.

For most asset classes and cities, average cap rates have been stabilizing since 2013, with very small variations in comparison to overall cap rate compression during the course of 2011 and 2012. Yet, over the last two years, these small, single-digit basis point compressions have stretched OCRs to historical record lows for both Tier 1 Regional Malls, (4.95% in Q4 2014) and Single Tenant Industrial properties (6.21% in Q4 2014).



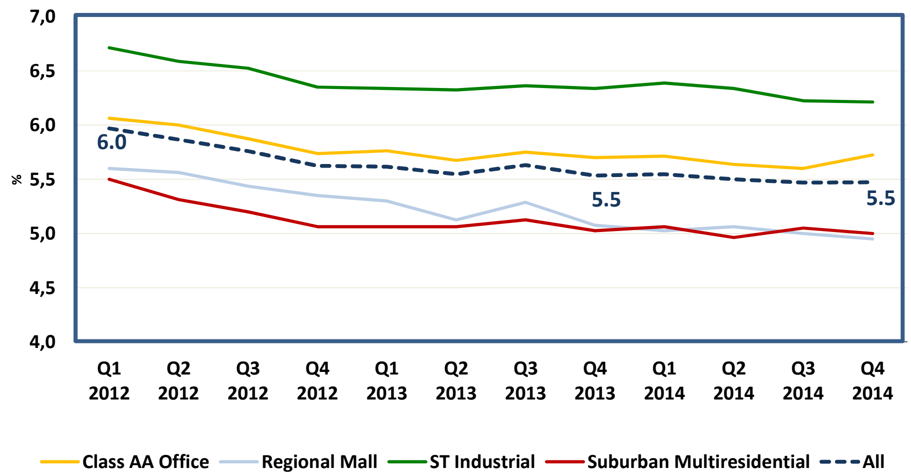
Over the same 2 year period, the national average for Suburban Multiple Unit Residential properties has hovered up and down between 4.96% and 5.06% (when excluding Q3 2013's results), with no sign of a firm trend. With 2014 now behind us, the most interesting signs for 2015 point to this quarter's 13-basis-point hike in the Downtown Class AA office market.

The average OCR for Downtown Core Class AA stands at 5.73% in Q4 2014, which is basically the same as its Q4 2012 level, but stands out as the highest level in 2014. It is also the only of the four asset classes to have seen no year-over-year decrease in cap rate, not even single digit. In fact, all cities recorded a slight upward swing, with the exception of Vancouver which remained unchanged.

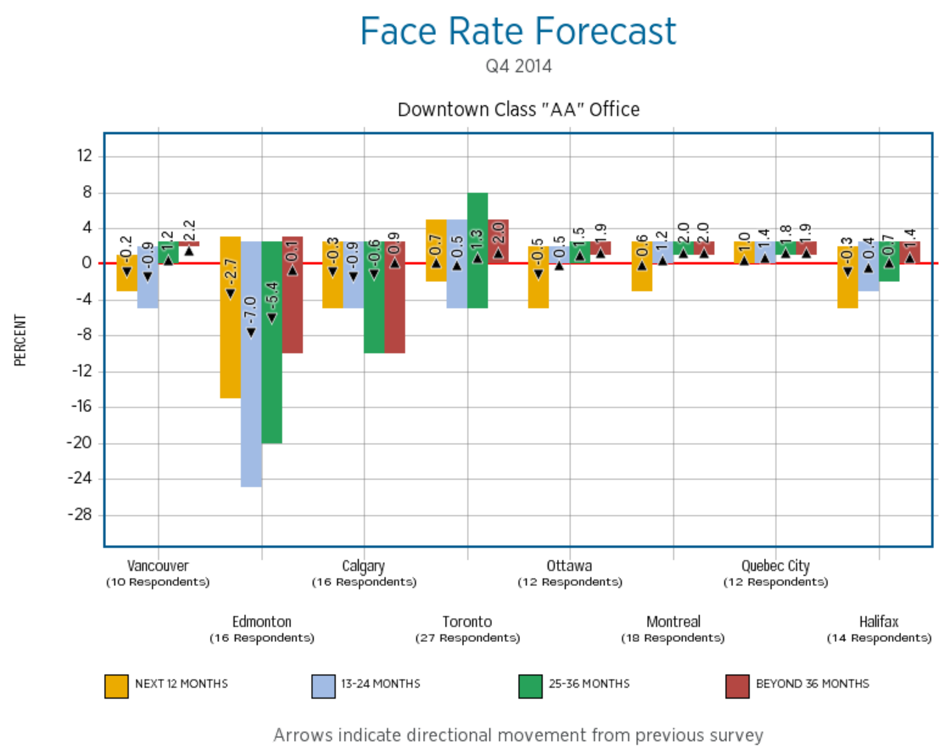
The increase in average OCRs was more noticeable in two markets: Halifax (+20 pts) and Edmonton (+30 pts). These are two cities where recent, on-going and planned development activity in the downtown core is raising concerns of oversupply. In Halifax, available rate in the Class A market jumped from 7.9% to 13.4% over the last year as more than 600,000 sq. ft. of Class A space was developed in 2014, which represents an 18% growth in inventory. In Edmonton, three projects totaling 1,735,000 sq. ft. of new Class AA office space, scheduled to come onto the market between 2016 and 2018, are raising serious concerns and have caused some landlords to reduce face rates by as much as 10% over the second half of 2014.

Demand for the new buildings is principally coming from relocation, whereby existing tenants are moving to these buildings. The backfill from the vacating tenants will add another 890,000 sq. ft. of vacant space to the market. In light of historic annual positive absorption for Class A space averaging 100,000 sq. ft. per year, it could possibly take upwards of 8-10 years for the market to return to an acceptable downtown vacancy level unless some older buildings are removed from the inventory and/or the province or other large occupier moves into the newer space.

OCR Trends - 4 Benchmark Asset Classes

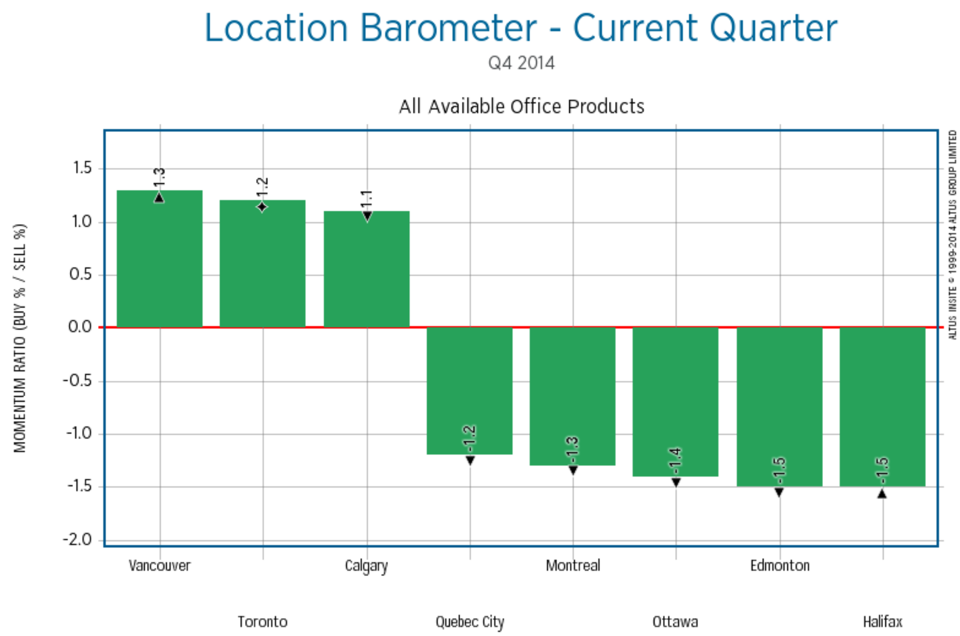


Any long-standing oversupply of office space, in these and other markets, will influence office market rents and the survey results are starting to telegraph this change in perception, as shown in the Face Rate Forecast Chart below. It is important to note that the Q4 2014 survey period preceded the recent and sudden drop in oil prices, which should have an impact on some of the Q1 2015 survey results for Edmonton, and more significantly for Calgary. Halifax, on the other hand, may see some improvement due to the ramping up of shipbuilding activity. Not surprisingly, the Location Barometer for office products shows Edmonton, Halifax and Ottawa (impacted by Federal Government's downsizing) with a negative buyer to seller ratio.



These survey results are based on investors' sentiment in reaction to changing market conditions. Since 2012, cap rates remained stable because all factors supporting record-low cap rates remained unchanged; low interest rates, scarcity of quality product for sale, strong leasing activity and most importantly, abundant capital. In the last few years, abundant capital seeking a home in the real estate market also fuelled new projects, which increased availability and backfill, in turn putting downward pressure on rents for certain market segments.

During recent business cycles, real estate prices appeared to be more correlated to financial market parameters than to brick-and-mortar fundamentals. Since interest rates are bound to increase over the long term, market participants' return expectations will be increasingly influenced by the market fundamentals , which directly impact property income after debt service. Prudent industry participants will be monitoring each market, asset class and even specific assets as their dynamics and drivers continue to evolve in both familiar and unfamiliar directions during 2015.



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.