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The Commercial Scene

Mortgage rates are higher, inflation rates are higher, so the rates of return on commercial property are higher ... right? Wrong!

Consider this the overall rate of return on unleveraged triple A retail property in the United Kingdom a decade ago was 6% to 6½%. Since then the U.K. has experienced rampant inflation (up to 20%) which has only recently, because of draconian money supply management (interest rates of up to 20%), been reduced to 13%. Yet those same triple A properties now sell at overall rates of return of 5% to 5½%. "Well, so what? you say; that's a different market".

Well yes it is, but something similar is happening too in the U.S. Over the past year the American Institute of Real Estate Appraisers has been working itself into a lather advising its members how to deal with the paradox of *negative equity dividend yields*. (Equity dividend is the rate of return on the purchaser's equity investment as represented by the cash flow remaining after debt service. A negative equity dividend yield simply indicates that the cash flow from the property is inadequate to fund the debt service. The purchaser, therefore, has to pay for part of his/her mortgage principal and interest payments out of his/her own pocket).

Has the world gone mad?

Quite probably! However, we don't think the property market has ... yet! It's just that they have tumbled to the same conclusions those canny Europeans, with their earlier experience of inflation, reached some 15 years ago. Property is a good hedge against inflation. Investors are willing to sacrifice current return for future appreciation and in their scramble for triple A properties, particularly in energy rich sunbelt areas of the U.S.A., they are having to do so. Canadian, British, Dutch, German, and Arab investors have been joined by home based life insurance companies, pension funds, and the like, forcing prices up and therefore the overall rates of return down, by 2½ percentage points over the past 4 years. Good quality office buildings which used to yield overall rates of return of 10% now sell at yields of 7½% to 7¾%. The Economist magazine in its recent American Real Estate Survey reported that the July 1980 sale of the Pan Am Building in New York returned an initial equity dividend yield of 2.3% to its purchaser, Metropolitan Life. They also reported equity dividend yields as low as 4% on first quality shopping centres. As mentioned earlier, the American Institute has repeatedly drawn attention to *negative equity dividend yields*.

The Economist, too, made another point which bears repeating. The pension funds' total investment in real estate in the U.S. is *still estimated at no more than 1% to 2% of their total assets*. Whilst we do not have the comparable figures for Canada we suggest that they would be similar. British pension funds by contrast have nearly 20% of their assets in real estate. A move in this direction in North America would have an enormous impact on the real estate market.

Our turn now, Atlantic Canada?Institutional Investors

Over the past decade there has been a steady, though perhaps not spectacular, growth of intra-national and international investment in Atlantic Canada. Over recent years the K-Mart Shopping Plaza, Dartmouth and the Brunswick Towers apartment buildings, Halifax, have been purchased by the German financed Lehndorff Corporation. Prudential Insurance of America purchased Parkway Mall, St. John, N.B.; Canada Life acquired Truro Mall, Truro, N.S.; and Imperial Life the K-Mart Plaza, Yarmouth, N.S. The most recent acquisition is that by Excelsior Life. They acquired a majority interest in the Bayers Road Shopping Centre, Halifax. The Edmonton based Oxford Group owns 50% of Durham Leaseholds Ltd., which in turn owns the Barrington Inn, the Canadian Imperial Bank of Commerce and Royal Bank buildings in downtown Halifax. Marathon Realty, the Canadian Pacific real estate subsidiary, acquired two office buildings in Halifax, the Young Tower and Metro I, together with a group of warehouses in the Burnside Industrial Park in Dartmouth as a result of their acquisition of Canadian Freehold Properties Ltd. in 1980. Cadillac Fairview owns an interest in the Toronto Dominion Bank Tower in Halifax. Prudential Assurance, a Canadian based, U.K. owned, life insurance company, has purchased warehouse and office properties in Halifax and St. Johns. And the list goes on

This steady increase of interest in Atlantic Canada will, we think, continue whether or not the promised oil boom comes to fruition. Indeed, perhaps as important as the oil boom itself is the publicity it engenders in establishing this area of Canada as a secure and promising area for investment. All of which begs the question, "are overall rates of return and equity dividend rates falling in Atlantic Canada too?". With regard to shopping centres, there was little evidence of this until recently and even now there have been so few sales that one cannot determine a clear downward trend. The matter is further complicated by the fact that population growth is so low in the Atlantic Provinces that shopping centres tend to be a risky investment. There is a plentiful supply of land and new centres were, until recently, constantly being built, thus eclipsing the older centres. If anything, the growth of the Bay and Sears department stores, in Nova Scotia anyway, threatens to exacerbate this trend.

So far as major office buildings are concerned it is difficult to get a clear trend, since there is a paucity of sales too. Certainly we would expect any office buildings located in the Halifax C.B.D. to sell at low rates of return in anticipation of the uplift in office rents that will occur, particularly after 1981.

Local Investors

If there is still no mad scramble to purchase the larger properties, what about those in the \$1 million and below range? Typically, the market in these properties is made up by local investors, singly or in partnership, utilizing mortgage financing for 75% or more of the purchase price. Equity dividend rates certainly do appear to be falling for apartment buildings. The rates of 8% to 10%, common 3 or 4 years ago, have now fallen to 6% to 8%. The impact of rent control has curtailed the rise in net operating income to the point where landlords are deferring maintenance and generally cutting costs where they can. These apartment properties are only experiencing increases in capital value in the order of 4% per annum. The low equity dividend rates are, therefore, more a reflection of high refinancing rates than a bullish market. Yet the fact remains that purchasers are willing to accept these lower dividend rates presumably in anticipation that the rent controls will be lifted within the next two years or so. MURBS, apartment buildings with transferrable tax shelter benefits, now sell at equity dividend rates of 2% to 4% and we saw one recently, a triple A building with new 12½% financing, which sold at a 0% equity dividend rate. As less apartment buildings are built, and MURBS become even scarcer, we expect to see negative equity dividend rates.

As for small office buildings (> 5,000 ft.² > \$250,000); fairly well insulated, brick veneer walk-ups, preferably with some parking, located in peripheral Halifax C.B.D. locations; we would expect these to experience good capital and rental growth over this decade and thus a lowering in present overall capitalization rates as purchasers anticipate this.