TURNER DRAKE & PARTNERS

Newsletter

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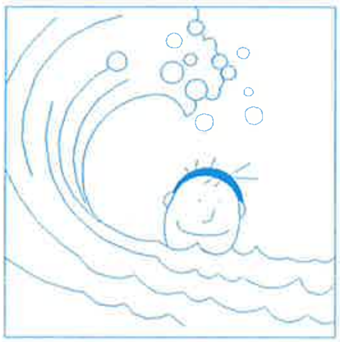
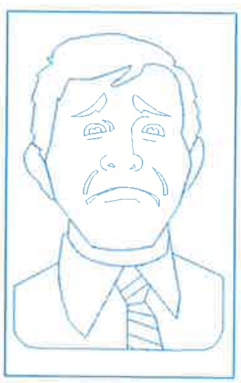
UPDATE



Summer wends its wet and windy way across Atlantic Canada, a perfect simile for the economy; short bursts of sunshine followed by periods of unremitting gloom. God may be in His heaven, but here in His country we are still waiting for Him to pop down to spread a little cheer around. Well, wait no longer, summer **is** here ... and to prove it we humbly offer Turner Drake & Partner's mid-yearly Newsletter crammed full of helpful advice leavened with our usual scintillating wit, a veritable cornucopia and all for the price of a few minutes of your time. So turn off the telephone, ignore that in-tray, add a dash of rum to your coffee and read ...

As avid readers of Newsletter know well, we are a shy and retiring bunch, wary of voicing our own opinion. No matter! At this, the dawn of the third millennium, we shed our natural reticence to boldly offer you our view of the property market during the remainder of the decade, as the 20th century totters to a close. And remember, you heard it here, first!

Getting the Monkey Off Our Back



Conventional wisdom runs thus: all governments are loaded down with debt ... apart from Japan which is loaded with lolly (ours). The average budget deficit of OECD economies as a percentage of gross domestic product has jumped fourfold since 1989 and their total public sector debt has soared from 42% of their GDP in 1980 to 63% today. Worse, as populations age, health and pension costs will mushroom and governments will sink still further into debt. Governments, other than Japan, will no longer be able to spend their way out of the recession (goodbye Keynesian economics) they must instead devote themselves to trimming budget deficits. Now, and this is where it gets a little murky, how do they do that exactly? Here in the land of the free, sound policies to achieve that end appear to be as rare as cod on the Grand Banks.

About 55% of Federal government expenditures are consumed by salaries, Provincial government wages eat up 75% of their budgets and Municipalities ... well they are too painful to contemplate. Yet each new government (with the exception of Newfoundland's Premier Wells) enters the arena replete with assurances that they will not cut civil service jobs or salaries. Now, if they don't intend to cut their wage bill, which constitutes the majority of their expenditures, how are they going to cut their deficit? Ah, raise taxes! Well, despite former finance minister Mazankowski's views on the matter, things look a little different down here in the trenches. There has been an explosive growth in the underground economy as Canadians upset at seeing their money wasted, are voting with their wallets by opting out of paying taxes. The GST was the straw that broke the camel's back ... so governments are losing out on income tax too as cash earnings go unreported. As Colonel Crow sagely remarked, the proletariat have reached their taxing threshold (naturally he put it rather more elegantly, but that was his gist).

"Inflation is Dead" ... and Other Fairy Tales

Governments at all levels are burdened with debt and will sink deeper into the mire in the future. They stagger under payrolls swollen during good times: politicians lack the courage, or the ability, to correct the situation. Canadians have reached their taxing threshold and even when the recession ends we will still run a deficit since about one third is structural. Sure, there will be some increase in tax revenue: G.S.T. will be increased to 10% after the next Federal election and Provincial P.S.T.'s will be "harmonized" with it to cover services, but the basic problem will remain. Unless our credit collapses, as happened with New Zealand, and foreigners no longer fund our debt, there will be no major change in the way government conducts its business. As Sam Walton of Wal-Mart observed, engineering change is the

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most difficult challenge facing any enterprise. In the absence of a Wal-Mart culture, most free enterprise firms have had change thrust upon them by the recession. Unfortunately the latter has not had the same impact on the public sector, which still lumbers aimlessly along, cheerfully doing what it does best ... very little, very expensively! (Or as Tory strategist Jodi White more tactfully put it recently to Kim Campbell "all sorts of private-sector companies have gone through horrendous restructuring and rethinking to adapt to changing times - not enough of that has occurred within government").

Assuming that we do not have a run on our dollar of epic proportions as foreigners bale out of financing our debt, what options does government have to cut its costs without cutting its (public sector) vote? You've got it! They'll print more money! Ipso facto, expect inflation to rear its cute little head again in the next couple of years.

The Property Market

Where does this leave the property market in Atlantic Canada? Real estate has traditionally been purchased as a hedge against inflation. No inflation, ergo little motivation to acquire real estate. Add to that, the fact that most market sectors were suffering from over supply **before** the recession started, that financial institutions willing to loan fresh mortgage money without securing your first born as collateral are scarcer than hen's teeth, and it is easy to see why the market is in the doldrums. How long will it remain there? It depends ...

Market sectors that primarily appeal to owner occupiers, such as **industrials** and **small office buildings**, are already showing signs of recovery as the economy starts to pick up. Our Brokerage Division has already sold more industrials in the last year, than in the previous three years combined. However prices have not recovered and industrials in major metropolitan areas such as Halifax-Dartmouth, that were hard hit by the recession, are transacting at levels equal to 50% to 70% of their pre-recession values. Lack of financing is endemic throughout Atlantic Canada and is a major determinant of low values.

The market for investment grade properties such as **shopping centres, office buildings** and **multi-use industrials** varies between "thin" and "non-existent" throughout the region. There is an oversupply of this type of space on the rental market, resulting in high vacancy rates especially for C.B.D. office space in St. John's, Newfoundland and Halifax-Dartmouth, Nova Scotia. Traditional purchasers such as the mutual and pension funds are notable by their absence. They will return as inflation picks up, buying opportunities in Ontario and Quebec dry up, and vacancies fall. Look for a shortage of office space in the Halifax C.B.D. by 1998 and in the St. John's C.B.D. by ... quo vadis Hibernia?

It will be three to five years before this market sector regains its sparkle. Even then we expect most purchasers will be from within the region, rather than from outside, as was the case before the recession.

The **hospitality industry** continues to suffer. Overbuilding, encouraged by ACOA and other Federal grants in areas such as Sydney, Nova Scotia, St. John's, Newfoundland, and Summerside, P.E.I. devastated hotel values **before** the recession trotted along to give a helping hand. The hospitality industry in all four provinces has been hard hit by the recession and has not yet recovered. Some offshore money is available for mortgage financing. We are probably looking at the end of the decade before this market sector recovers its mid 1980's buoyancy.

Apartment Buildings now appeal only to local investors and units that are owned by national institutions such as the life companies, will be sold as soon as financing again becomes available. Rent control in Nova Scotia has worked its magic and many properties are tired and exhibit deferred maintenance. We see this sector as being the first investment type property to recover because of its wide appeal to local investors: probably within the next two years.

PROPERTY TAX DIVISION

"Civil servants in this country have a comfortable contempt for the general public" observed the Globe and Mail recently. Golly gee, what a relief, we thought we were so blessed only in Atlantic Canada.

To be fair, there has been a change of attitude over recent years by many of the assessors with whom we deal. Our representations on behalf of the property owner/occupier used to be met with righteous indignation by the assessor. It was outrageous: not only had the unfortunate taxpayer the temerity to question their assessment, they had retained professional advice too. What's more these, these ... gunslingers ... actually insisted on reviewing the assessment cal-

Colonial Inn, Moncton, N.B
($32,000/annum in tax savings)

culations to see if they were fair and equitable. It was enough to make Stalin rotate in his grave. Many assessors clutched their assessment records protectively to their bosoms; **nobody** was going to see **their** figures, it was up to the taxpayer to prove **them** wrong; **they** were civil servants: a nomenclature that often proved to be a contradiction in terms. Happily things have changed for the better, glasnos now extends all the way to the New Brunswick border ... the eastern border. Yes sirree, N.B.'s provincial assessment department, the Orwellian named "Geographic Information Corporation" (GIC) is still fighting on the cold side of the Cold War with a policy of secrecy that would crack a smile on the face of any self respecting KGB officer. GIC operatives are sworn to secrecy: taxpayers are not allowed to peek, much less have access to their own assessment records. GIC explains their appeal process thus "initially the property owner can refer the assessment back to the appropriate office for review (approximately 8,000 - 9,000 do so annually). Upon Referral the assessment is reviewed, re-inspected and the owner/manager **queried**. The assessment is then reconsidered in light of the above and a Referral Register issued to the owner that either confirms or alters the assessment." Ah, theirs to command ... ours but to obey. We kid you not, this is quoted verbatim. True "should the property owner continue to be dissatisfied" (petulant fellow) "with the level of assessment on the property following Referral, an Appeal to the Board can be initiated" ... but in two out of the three cases we have taken to the Board, GIC has not offered any evidence (and has indicted that it will not do so in the fourth case which is before the Board now). The GIC operative sat mute, struck dumb ... whilst our client had to pay for our presentation because the Board has no authority to award costs. Watch out though GIC ... the proletariat are getting restless ... look what the naughty fellows did to the Berlin wall.

VALUATION DIVISION

Appraisal Standards ... What Standards?!

GREYMAC TRUST
SEAWAY TRUST
CROWN TRUST
CANADIAN COMMERCIAL BANK
SASKATCHEWAN TRUST
FIRST CITY TRUST
STANDARD TRUST CO.
COOPERANTS MUTUAL LIFE INS. SOC.
CENTRAL GUARANTY TRUST CO.
SOVEREIGN LIFE INSURANCE CO.
ROYAL TRUST CO.

In November 1992, our company president Mike Turner resigned in disgust from the country's appraisal trade association, the Appraisal Institute of Canada because to continue membership would in his words "lend my name to a sham. The appraisal industry is in a mess and despite twenty years of protestations to the contrary, standards continue to deteriorate. Unlike the Americans who are making a determined effort to clean up their mess, we continue to rely on an industry trade association to do it for us: a solution akin to naming the fox to guard the chickens. Meanwhile the awful parade of bank, trust and insurance companies that have collapsed under the weight of bad commercial loans over the past 10 years based on faulty real estate appraisals, has destroyed confidence in real estate as an investment vehicle. The problem has been magnified by the recent recession to the point where most open ended mutual funds have now suspended redemptions and every financial institution in the land has taken a substantial write-down on its commercial loan portfolio. As a result new mortgage credit is much restricted, causing hardship to businesses who rely on their real estate assets as a means of raising capital.

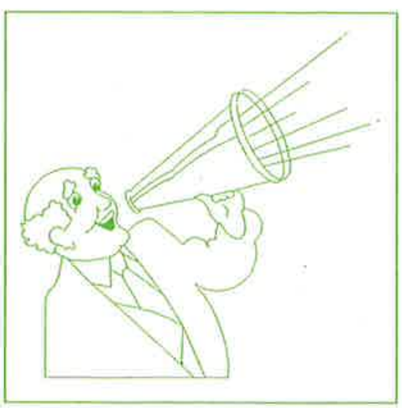
How did we get into such a mess? The appraisal community is not the sole cause of the problem ... the institutions and regulatory agencies too must shoulder part of the blame; but actions taken by trade associations, primarily the Appraisal Institute of Canada, have in my view exacerbated the situation to its present crisis level even though such actions may have been taken with the best of intentions. There has been a marked decline in appraisal standards over the past five years. I base this conclusion on the appraisals which are submitted to our firm's Brokerage and Valuation Divisions.

I am cognizant of course that property values have fallen, in some cases quite spectacularly, but that does not explain cases such as the brothel appraised at $760,000 (really worth $230,000 ... on a good night), the bowling alley appraised at $520,000 (it subsequently sold for $90,000), and others too numerous to mention. Indeed I now routinely see appraisal reports undertaken for financing which grossly overvalue the property: appraisals which, if undertaken south of the border, would result in a jail sentence for fraud ... what has changed to bring about this situation?

The "Moral Hazard" Problem

In my view a major contributory factor to the decline in appraisal standards was the decision by the industry's main trade association, the Appraisal Institute of Canada, to mandate blanket professional liability insurance for all of its members irrespective of whether they were "insurable" by a private carrier. The trade association by virtue of its predominance in the industry, has been able to secure legislative recognition with such bodies as the Ontario Securities Commission (O.S.C.) and the Federal Government ("Investment Valuation [Canadian Companies] Regulations") and as a consequence membership is virtually obligatory for most appraisers. In 1988 this professional liability insurance became a cost of membership and each member was insured individually. Prior to that date the liability insurance had to be purchased on the open market by the employing appraisal firm. There was considerable incentive therefore for each appraisal firm to maintain sound appraisal standards, since to do otherwise would invite an insurance claim which would often result in loss of future coverage. Since 1988 however, it is the individual who carries the coverage and the Appraisal Institute of Canada refuses to exempt appraisers employed by firms such as our own, who carry coverage with a private carrier, even when the scope of that coverage is more comprehensive than their own. Since the Appraisal Institute of Canada insures its members, rather than the appraisal firm, responsibility for maintaining standards has been transferred from the appraisal firm to the individual appraiser. Most appraisers work on a "commission" basis whereby their renumeration is geared directly to output. As a consequence they are under considerable pressure to "perform" ... or not eat. Formal education requirements are low and training is usually rudimentary ... entry barriers to the industry are minimal. The concomitant pressure to cut appraisal standards in order to increase output is obvious. Since the trade association levies the same premiums across each class of membership, regardless of claims history and since coverage is obligatory and hence available to all, the risk of undertaking negligent work has been substantially diminished. Whilst the Appraisal Institute's scheme was no doubt conceived with the best of intentions, the concomitant moral hazard problem has, I believe, contributed to the appalling decline in appraisal standards."

The Solution



The Americans and British do not share our enthusiasm for entrusting the public good to trade associations, they are understandably somewhat skeptical of the latter's motives. It is difficult to comprehend why we continue with a policy which has been such a demonstrable failure. The real loser in all of this is the Canadian consumer; the Central Guaranty bail-out alone is projected to cost the Canadian Deposit Insurance Corporation a staggering $4.3 billion according to recent reports. Instead of the Canadian consumer continuing to suffer, I advocate letting the free market operate by **deleting all reference to all appraisal trade associations from all Federal or Provincial regulations.** Quite apart from the morality of conferring monopoly powers on what are essentially private clubs interested in their own gain, such recognition does considerable harm. If a body has a monopoly power it has no incentive to improve its standards.

I also suggest taking a leaf out of the American book by **requiring that the financial institution, rather than the borrower, retain the appraisal firm for any appraisal undertaken for financing and that the appraisal firm, rather than the appraiser, carry professional liability insurance (a copy of the policy should be included in the appraisal report).** Contracting directly with the appraisal firm would eliminate the conflict of interest that is the cause of many of the present problems. (When the appraisal is contracted by the mortgagor the latter can apply pressure on the appraiser to come up with the "right" figure.) Requiring the appraisal firm to carry proper professional liability insurance would ensure that firms which did not make the grade would be eliminated, since they would be uninsurable."

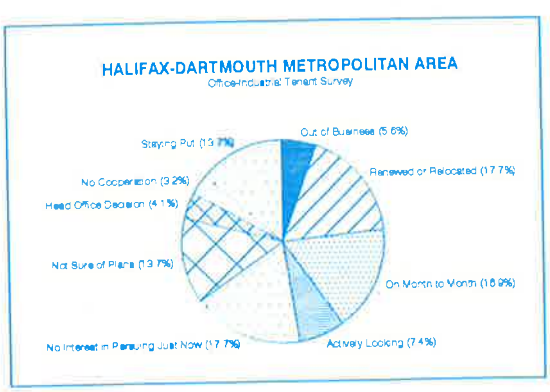
BROKERAGE DIVISION

Our Brokerage Division operates mainly in the Halifax-Dartmouth metropolitan area and is active in leasing (retail, office, industrial) and sales (industrial, commercial, investment property and raw land for development). Our marketing reach extends across the country because our client base is continent wide. We cheerfully work with other brokers, both within the region and across the continent.

Sales

Demand is strengthing for **industrials** and there is at last a market for them. Prices however are only about 50% to 70% of their pre-recession values: consequently vendors are reluctant to offer their properties for sale since purchasers are not available who are willing to pay prices which cover the mortgages. Demand is particularly strong from first time buyers. However since they are seeking only small buildings (±5,000 $ft.^2$) it is often cheaper for them to build. There is a fair demand for buildings in the 15,000 $ft.^2$ to 20,000 $ft.^2$ range, also from small space, owner occupiers, who hope to lease out the space that is surplus to their requirements. Demand is very weak for buildings in excess of 20,000 $ft.^2$. The market for **apartment buildings** has softened during the past quarter and is very weak in all areas other than Halifax Peninsula. Even there demand is only fair. The **office sector** continues to be plagued by low rents. Most vendors have withdrawn their properties from the market, since there is no market for them at prices comparable to their cost of acquisition. There is a demand for very small buildings (5,000 $ft.^2$ to 10,000 $ft.^2$) but the main source of financing, the banks, have reduced their loan to value ratios to 50% (60% if you have an excellent track record). Inclusion of your first born as collateral is pretty well obligatory. Demand for **shopping centres** continues to be weak, and the strengthening now being experienced in Ontario has yet to reach Atlantic Canada. Even strip malls, which appeal to local investors, have difficulty in finding a market. There is a fair demand for serviced **subdivision land** in neighbourhoods that appeal to first time home buyers. However potential subdivision land where services are not available, attracts little interest, partly because of environment controls, arsenic and other water contaminants, but primarily because of the lack of financing.

Leasing



In late June/early July we updated our survey of office and industrial tenants, conducted two years' earlier. As the pie graph indicates, one in twenty tenants have gone out of business since our previous survey. About a quarter of all tenants are now on short term (month-to-month leases) or are actively looking for alternative accommodation.

The first real signs of the recovery are now evident by the increase in leasing activity. So far this year we have leased about 50,000 $ft.^2$ of space with a total rental value of $2.9 million. It encompasses everything from light industrial to Class A office space.

Demand for **industrial** space is now fair and has strengthened over the last three months. **Office** demand is firmer than last quarter and there are a surprising number of tenants looking for 300 to 500 $ft.^2$, either new firms, or companies moving into the region. Demand for **retail** space is unchanged, it continues to be weak.

CONSULTING DIVISION

Given the present state of the property market, we find ourselves in the same position as the priest who discovers there is no god. A major factor in the present situation is the lack of availability of mortgage monies. The financial institutions, lemming like, have "got religion" after their excesses of the 1980's. Acting with the zeal of the newly converted they are adopting a hands off policy when it comes to loaning new money on real estate. As a consequence prices are in free fall in some market sectors: the financial institutions have succeeded in creating a self fulfilling prophecy, real estate is risky because prices are falling ergo avoid loaning money on it, ergo it falls in value ... so our Consulting Division is busy advising clients (usually financial institutions) on property work-outs. Fortunately we are only faced with two problems: a lack of tenants ... and a lack of purchasers.

Property Work-Outs

In undertaking any real estate work-out, it is necessary to identify which strategy is best for the property. Michael Porter has demonstrated that there are three generic types of competitive strategies available to business: they are just as applicable to real estate. **(1) A low cost strategy** consists of striving to be the low cost producer by focusing on operating costs. **(2) A differentiation strategy** consists of seeking to differentiate one's product (space) in one way or another from those of the property's rivals. This may require repositioning the real estate in the market place. **(3) A focus strategy** consists of concentrating on catering to a narrower group of tenants and a limited part of the market, rather than going for the whole market with a something-for-everyone approach.

Rolling Up Our Sleeves

In order to implement a low cost strategy it is necessary to reduce operating costs. Real estate/occupancy taxes are usually the major operating expense and can represent 48% of the total operating costs. They are the soft underbelly, since most properties, especially if they are suffering from cash flow problems, are overassessed.

Calling on the expertise of our Property Tax Division, we audit the assessment records and this information, supplemented by a valuation of the property by our Valuation Division, is utilized in the negotiations with the assessor to reduce the tax load to more manageable proportions. There is well established case law to support the position that the assessment has to be based on the property's value at the appropriate assessment base date ignoring future potential: in other words the assessment is based on the property in its existing physical and fiscal condition and should not reflect the potential of the work-out. The impact on the "bottom line" can be dramatic. In addition we review the other operating costs and compare them with industry benchmarks, and the property's operating history to determine if they can be decreased ... or if it is necessary to increase them. An example of the latter is maintenance. A property owner, struggling to hang on, will cut maintenance and repairs until things improve. Unfortunately if maintenance is long deferred, as is the case with the current recession, a Catch 22 situation develops: the property cannot compete because of maintenance problems ... and the owner cannot adequately address the situation because of difficulty in attracting and retaining tenants.

As part of the process of determining which strategy to employ (low cost, differentiation, focus) we undertake a physical audit of the property. This allows us to identify items of deferred maintenance and to determine if there are other physical features which will militate against it as a competitive entity. We focus on the reasons tenants locate in the building vis à vis competing buildings .. and the reasons they locate elsewhere. Is the parking adequate; if not is it possible to address the problem in a cost effective manner? What about exposure; can it be improved with signage, demolition of obstructive buildings, or by cosmetic improvements? Are the common areas clean and well maintained: do they project the desired image ... or do they "turn off" potential tenants? We also measure all leasable areas, utilizing the appropriate standard method of measurement and verify that each tenant is paying its fair share of the operating cost burden.

We undertake a full lease analysis and compare the rental and leasing structure with competing product in the market place both as an aid to determine the correct business strategy, and also to assess the property's competitive position. The existing tenant mix is important, not just for shopping centres, but also as a useful guide to the property's market position.

And ... we've run out of Newsletter. If you would like more information on how we can assist you with a property work-out call Mike Turner at 429-1811 or toll free 1-800-567-3033.