TURNER DRAKE & PARTNERS

Real Estate Counsellors, Brokers & Valuers
Registration to ISO 9001:2008

Newsletter

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INVESTMENT PROPERTY: SHIFTING SANDS (Continued)

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The Past Past (1980-1989) Recap

Our previous Newsletter (Spring 2008) recounted the events unleashed by Ronald Reagan's election to the Presidency of the United States in 1980. The tax cuts and financial deregulation that followed, resulted in a 72% increase in the country's gross domestic product during that decade but they also culminated in a financial crisis, the collapse of 1,000 Savings and Loans Associations, which ultimately cost American taxpayers $124.6 billion. The Canadian government attempted to soothe its taxpayers with assurances that things were different here: a couple of years later the Trust Company crisis laid to rest that fond hope. Trust companies, many household names, went down like ninepins. During the dying days of the decade an entire sector of the Canadian financial system disappeared. Then the Thai baht collapsed, the result of over exuberant property lending by that country's banks. The contagion spread to Japan, whose banks had exhibited similar malaise, and then around the world. We pin point May 1990 as the start of the recession in Atlantic Canada, based on the reduction in residential sales volume and prices, an activity we have tracked continuously since 1978. In reality however the commercial property market started to feel the pinch in 1989 as credit dried up. During the ensuing two years the market seized up: credit was unavailable, properties could no longer elicit prices which would allow vendors to liquidate their existing mortgages; sales activity ceased. In 1992, vendors forced by financial pressure to sell, faced an awful fact, an average 50% of their nest egg had evaporated; its value eviscerated by a banking system paying penance to past excess by refusing to lend at all. Our financial system had found religion, credit was unavailable because commercial property was worthless… ipso facto such was the case. If like us, you lived through that era, you may now perforce be experiencing a feeling of déjà vue… together with a sense of grievance that you have to suffer through it all again.

IN THIS ISSUE

The Lost Decade (1990-1999)

The market meltdown which hit Atlantic Canada in May 1990 was not immediately apparent. Until 2009 sales information was not public knowledge in the three Maritime

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Provinces (Nova Scotia still jealously hoards it), and the Newfoundland registry office is such a mess, effectively there is none there either. Because the markets are imperfect, some uninformed purchasers blissfully unaware of the precipitous fall in property values, continued to buy at 1989 prices through to 1992, **provided that they could get financing.** The commercial market meltdown was therefore a three year event which had its beginnings in 1989 (as evidenced by reduced sales volume, but not lower prices), gathered pace during 1990 and 1991 (few sales, little credit), and produced some evidence of falling values in 1992 (foreclosure sales, but some less knowledgeable purchasers still buying at 1989 prices if financing was available). By 1993 there were sufficient "distress" sales occurring that all but the obdurate, a.k.a. some Provincial assessors, realised that property values had shifted dramatically downwards. This was no minor price adjustment and it was made all the worse because (1) the banks and other sources refused to provide mortgage financing to facilitate property transactions, (2) owners of investment real estate, primarily the pension funds, panicked and started to liquidate their portfolios, (3) the owners of trophy buildings such as Purdy's Wharf in Halifax cut their rents dramatically in order to capture whatever weak demand existed, thus triggering a similar reaction from properties on the rungs below them, (4) oversupply of space in some markets was exacerbated by new supply coming on stream which had been started before the recession. It was not a happy time. Open ended Limited Partnerships were forced to close off redemptions since they could not raise funds from property sales. The property markets effectively seized up and liquidity was slow to return. Sales activity, other than foreclosure sales, really did not start again until 1995 led by hotels/motels, then apartments (1997), industrial (1997/1998), offices (1998) and retail (1999). The recovery in prices took much longer. It has taken 19 years for some properties to recapture the value they lost in 1990; and most of the recovery has occurred post 2000. The reason the recovery in capital value was so prolonged was not lack of occupier demand, but rather restricted access to credit. The creation of new types of financing such as the conduits which agglomerated mortgages and then resold shares in them to many different purchasers, and the metamorphis of Limited Partnerships into Real Estate Investment Trusts (REITS), followed very gingerly by the banks, gradually led the commercial property markets out of the wilderness. However progress during the 1990s was slow and painful. Residential property values had not suffered the same collapse in 1990, as their commercial brethren, but for them too it was a lost decade. Canadians were paying for government excess in prior decades as the Federal, and Provincial, governments struggled to eliminate their budget deficits. Canada, Japan and Germany stood by as residential property values soared throughout the remainder of the industrialised world. For Canadians this was a lost decade: the median family income in 2000 was virtually the same as it was in 1990, after adjusting for inflation. Their main "wealth" asset, the family home, too had shown little improvement in value. The average price of a dwelling in the Halifax Regional Municipality was $108,978 in 1990, and $116,679 (expressed in 1990 dollars) in 2000. Property therefore held little appeal as a wealth creating investment particularly as the stock market was on a tear. From 1992 to 2000 the latter experienced a period of rapid expansion, fuelled in part by the growth in technology stocks. This "dot com" boom came to an end in 2000; between September 1st 2000 and January 2nd 2001 the technology heavy NASDAQ dropped by 46% in value, and by October 2002 it had declined by 78% from its previous high. The WorldCom and Enron frauds which surfaced in 2001 and 2002 were the final curtain. Suddenly real estate was an attractive investment vehicle again and Canadians, having paid the piper, started to get richer again. Incomes rose and house prices took off. Pension funds et al rushed into property investment with the same happy abandon, last exhibited when they exited the field a decade earlier. We do not have figures for Canada but Linneman Associates, Philadelphia, calculate that the total capital (private and public debt, plus equity) invested in United States' Commercial Real Estate went from a low of -$40 billion in 1992, to $255 billion in 2006.

Happy Days Are Here Again (2001 to 2007)

From 2001 to 2007 the residential and commercial property markets in most parts of the world roared ahead. To be sure there were a few warning voices, mostly ignored. The Economist was the most vocal. Noting the propensity of people to treat residential real estate, especially their own homes, as investment vehicles rather than simply as places to live, the magazine had started to compile a worldwide quarterly house price index. It postulated that as house prices increased, home owners spent more of their disposable income and thus stimulated the economy. Falling house prices would have the reverse effect. By Dec. 5th 2005, it was warning that the American market "now seems to be coming off the boil". Nevertheless, although residential prices in the United States were falling, the mood of commercial property investors for the first half of 2007, was decidedly bullish. Presumably they were not yet Economist subscribers.

The change in a property's Capitalisation Rate (calculated by dividing the Net Operating Income by the Sale Price, expressed as a percentage) inversely tracks changes in value (assuming a stable Net Operating Income). A falling Capitalisation Rate for any market sector indicates market demand for purchasing property is rising faster than rental demand: investors are accepting lower yields. The impact of what Anthony Downs labelled the "Niagara of Capital" (Urban Land Institute, 2007, ISBN 978-0-87420-999-0) flowing into commercial real estate was two fold: (1) Capitalisation Rates declined as investors priced out risk by accepting lower yields and (2) Capitalisation Rates for the various types of real estate (office, retail, apartment, industrial) converged. From the ends of 2000 to 2007, Capitalisation Rates declined and compressed as investors priced away risk between real estate and other types of investment, and between the various types of real estate. The two trends are clearly evident in the graph shown on the following page:

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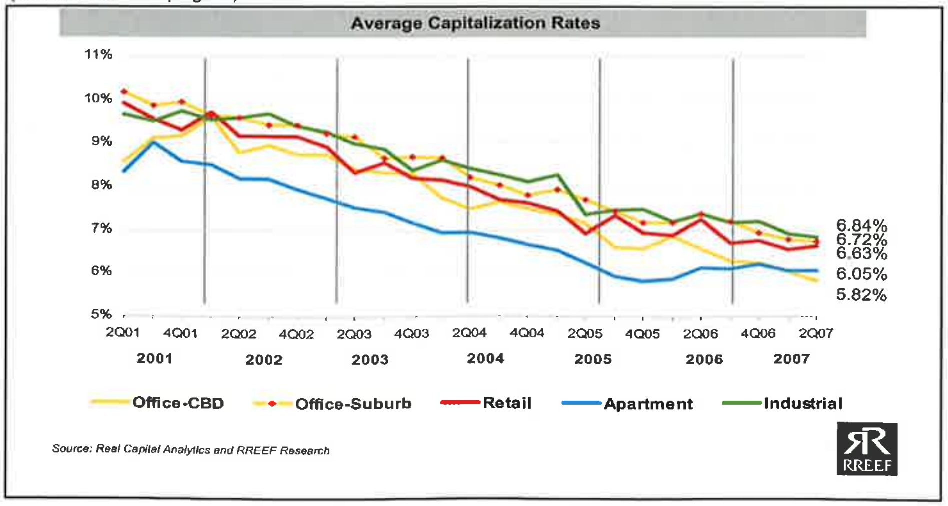

Source: Real Capital Analytics and RREEF Research, October 2007.
(Reprinted by permission of RREEF Research)

At the beginning of 2001, for example, investors required yields of 8.25%, (apartments) and 10.25% (suburban office). By the end of 2007, investors' yield expectations had declined to 6.05% (apartments) and 6.72% (suburban office) and their expected yield premium for suburban office over apartments had compressed from 2% (2001) to 0.67% (2007).

The Capitalisation Rates captured in the graph refer to the United States. In Atlantic Canada, Capitalisation Rates declined by an average of 152 basis points (1.52%) over the period 2001 to 2007. They also compressed: the spread between apartments and offices was 208 basis points (2.08%) in 2001 and 90 basis points (0.90%) in 2007.

Then, it all went wrong.

Financial Failure (2007-2008)

By the end of 2007, the wheels had started to fall off the financial sector. All those clever conduit financing deals proved on closer inspection to benefit the brokers rather than those holding the paper, and the property owners. The inflexibility inherent in a mortgage that had been repackaged with other loans, sub-divided and resold to many different lenders, reared its ugly head. Once the genie was out of the bottle how did you get it back again if (when) the mortgagor wanted to refinance mid-term? By the end of September 2007, the crisis over asset backed commercial paper (ABCP) hit the windshield with the formation in Canada of a committee headed by Mr. Purdy Crawford, to attempt to unfreeze finance backed by it. Meanwhile it emerged that the financial community in the United States had forgotten all about the Savings and Loan crisis in the 1980s (so yesterday!) and, convinced they could defy gravity had happily loaned billions of dollars to home owners who hadn't a hope in hell of being able to pay them back. HSBC, the world's largest bank started the ball rolling in February 2007 by writing down its holdings of Mortgage Backed Securities by $10.5 billion (US). Canada's banks, encouraged by government owned CMHC, had earlier been anxiously joining party with high ratio, 40 year amortization residential mortgages but had been publicly chastised by party pooper, Bank of Canada Governor David Dodge; so missed most of the fun. In September 2007 Northern Rock, a small British bank which had borrowed short in order to lend long, fell victim to the freeze in the credit markets. It experienced a run on the bank, lost 73% of its value and one of its managers (two customers locked her in her office after she refused to let them withdraw £1 million from their account).

During 2008 the stock market continued to crash, those of us with RRSPs contemplated Freedom 95, and the US bank Lehman Brothers went bankrupt. American Treasury Secretary Henry Paulson announced that the world was going to end (financially). Investors took him at his word, converted their holdings to cash and stuffed it under their matresses. The U.S. Federal Reserve is now busily printing more of it, apparently in the fond hope that somebody somewhere will spend it. In Canada, our ruling minority government calmed the nation by claiming no action was required, the opposition parties threatened to throw them out, the Governor General gave them all a spanking, and every politician in the land is now gleefully burdening all of us with debt again.

Meanwhile the property markets in Atlantic Canada are starting to cough and splutter. Credit is more difficult to get, or is unobtainable; loan to value ratios have fallen, debt coverage ratios have risen. Sales, apart from apartment buildings, are stalling. Capitalisation rates are climbing; up about 91 basis points (0.91%) over the past twelve months.

The Aftermath (Post 2008)

Warren Buffett opines that the United States' economy has "fallen off a cliff" and wisely declines to predict the height it has to fall, or when it will reach bottom... but only that eventually the world's most entrepreneurial economic system will bounce back. Canada will follow suit. What clues can be drawn from the 1990 recession? Is Atlantic Canada teetering on the edge of another property market meltdown?

The Wharton School's 1998 research paper on the financial crisis which washed ashore in Atlantic Canada in 1990, determined that commercial property values collapse because of (1) a sharp fall in demand, or (2) a rapid rise in supply fuelled by easy credit, or (3) both of the foregoing. Atlantic Canada's market meltdown was caused by a severe recession which sharply curtailed demand, during a period of rapidly expanding supply. The latter resulted from over-exuberant lending by the banks (offices, multi-tenant industrial, retail), CMHC (apartments) and government agencies such as ACOA (industrials, hotels, motels). Signals such as rising vacancy rates were ignored. Today the region does not face the same over-supply situation which heralded the onslaught of the 1990 recession. The danger lies in demand... and the determination of government to spend their way out of the recession by embarking on projects lacking any other rationale, but whose impact threatens to destabilize the supply/demand equilibrium by encouraging building that is not required.

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The 1990 recession lasted for two years: GDP dropped by 3.2% in the first year; growth was almost none existent the following year. Commercial property prices in Atlantic Canada plunged during that period. It took 5 to 9 years from the start of the recession (apartments 7 years, industrial 7 to 8 years, offices 8 years, retail 9 years) before demand returned. Recovery to pre-recession capital values took 10 to 15 years. Today there is little surplus supply so the fall in property values will be driven by softening occupier demand; we do not expect the same erosion in capital values. However the reduction in credit availability, its high cost and the lack of confidence engendered by the financial crisis is also persuading investors to reprice risk. We project that overall capitalisation rates will increase by 100 to 200 basis points (1% to 2%) over their 2006 levels and that the spread between the various property types (apartments, industrials, office, retail) will widen again to historic levels. Market values will fall by 10% to 25% depending on the property type and its location. The recovery in capital values will be rent rather than yield driven, and will track the recovery from the recession.

Linneman Associates can be found at www.linnemanassociates.com The Urban Land Institute lives at www.uli.org. RREEF resides at www.rreef.com. The Economist calls www.economist.com, home.

EGG HEAD (DOUBLE YOLK)

Nigel Turner, B. Comm,

Matt Whittleton, B. Comm

Our Consulting staff are a tenacious bunch. We hire the cream of the crop from the region's leading universities and then subject them to our gruelling six year training program, part of which comprises the University of British Columbia's Bachelor of Business in Real Estate (BBRE) degree. We are proud of them; they regularly top the charts Canada wide in the various courses. Nigel and Matt are the most recent winners of our Egg Head award. Nigel scored the highest score countrywide in UBC's Real Estate Development I course. This is the second time he has won our Egg Head award. Matt achieved the highest mark in the country in UBC's Canadian Real Estate Property Law and Real Estate Ethics course.

One set of exams, two Egg Head award winners! Congratulations, a wonderful effort guys: A+ all the way!

PROPERTY TAX DIVISION

Dartmouth, Nova Scotia
($22,628/annum - 89% in tax savings)

Nova Scotia - Taxes Tank

In May 2004, the Province of Nova Scotia enacted legislation which will, as years progress, increasingly shift the property tax burden onto the young, the old, the less well off, and employers. It set a Canadian precedent. Effective 2005, the residential assessment on which property taxes were based, was rolled back to a 2001 base year. This "capped assessment" was increased initially by 15% and 10% per annum. However effective 2008, the annual increase was "capped" at the increase in the Consumer Price Index. Since there is no limit on assessments that are capped, the owner occupier of a $1.0 million home enjoys 10 times the tax savings of a $100,000 capped assessment residence. The assessments of rental apartments and seniors' housing are not capped. When a residential property is sold the capped assessment is "reset" to current assessed values. The cap, which starts the following taxation year, is applied to the new assessed value. First time home buyers, young couples moving houses to accommodate the needs of their expanding family, householders moving for business reasons, and empty nesters downsizing, will increasingly bear a greater share of the property tax burden. Indeed two identical homes will now pay different amounts of property tax depending on their date of purchase. New construction is not capped during the year it occurs: home owners are now at risk if they renovate, or expand their home, because a portion of their capped assessment will be "reset" to current assessment levels. Business owners will be particularly hard hit by the residential capping because their taxes are not capped. Their share will continue to increase as the tax burden shifts to commercial properties. We estimate that the Province wide loss in annual assessed value in 2009 will be $2.1 billion; 50% higher than 2008. Effectively municipalities are losing the taxable assessment of a Halifax Central Business District every year due to the capping and will have to recover those taxes from non-qualifying residential taxpayers and commercial property owners… primarily the latter.

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The 2009 property tax appeal period closed on February 15^{th} so unless your property is enrolled in our PAMS^{TM} Property Tax Manager program, or you have already filed an appeal, you are too late to curtail your 2009 realty tax increase. However we understand that the provincial assessment authority, the Property Valuation Services Corporation (PVSC), will finally get its act together this year and publish their "pre-roll", albeit not until September. In 2007 and 2008, PVSC were too busy learning to articulate their new name (they were formerly Service Nova Scotia) and discovering where the "on" switch was located on their new computer system, to publish a pre-roll. As a result they have been inundated with appeals this year that would otherwise have been dealt with more efficiently at the pre-roll stage. Consequently municipal budgets are going to be less stable in 2009 because a much larger proportion of commercial properties are under appeal.

If you have filed an appeal, or if you should have filed an appeal but did not do so, now is the time to contact our Nova Scotia Tax Team, Giselle Kakamousias and Mark Turner at 1-800-567-3033 (429-1811 in HRM)

New Brunswick

Belledune, New Brunswick
($128,717/annum - 62% in tax savings)

The 30 day appeal period in New Brunswick ends on April 1^{st}. If your property is enrolled in our PAMS^{TM} Property Tax Manager Program we will file an appeal if the opportunity exists to lighten your property tax load. The basis for your 2009 assessment, as mandated by the Assessment Act, is the market value of your property on January 1^{st} 2009… in its *existing use* i.e. ignoring any development potential or other highest and best use. In determining market value you should look at the future, not the past… your property, may well be worth less now than in prior years. Past sales of similar properties, or even a prior sale of your property, may not be a reliable indicator of market value during the current economic climate. This is certainly the case if you have an investment property (apartment building, offices, retail, multi-tenant industrial). Investors are repricing risk and capitalisation rates are rising, so values are falling. Apart from CMHC insured loans for apartment buildings, credit has dried up, conduit financing has disappeared, so the pool of potential purchasers is much reduced. If your property is uniquely impacted by the financial crisis you should file an appeal (now called a "Request for Review'). For example if you are an automobile dealership you may be effected by reduced sales and, if you have a Chrysler or General Motors franchise, by the uncertainly over those marques. There is case law which clearly establishes that events known and publicly disclosed prior to the base date, have to be taken into account in arriving at the assessed value. We established that precedent seven years ago *(New Brunswick Publishing Company versus Director of Assessment, NBARB, November 2001).* Although the assessed value is not supposed to include the value of the franchise, automobile dealerships are configured to reflect the image dictated by the marque so the potential loss of the franchise impacts value.

If you have a manufacturing facility which has been forced to close, Service New Brunswick will probably have reduced your realty assessment by 50%. This is pretty well their standard practice. However this is not enough! There are probably good grounds for reducing your assessed value by 80% to 90%. We recently negotiated a reduction in the assessment of one plant to $2.0 million: it was built four years ago at a cost of $15.0 million. If your facility is working at reduced capacity you are probably over-assessed.

If you own a hotel, motel, restaurant or other hospitality type facility and are faced with declining bookings you are probably over-assessed.

Do not dismiss the possibility of an appeal even if your property is assessed at less than its market value. Your property may be unfairly assessed because of errors in the tax assessor's methodology or computations, or because the physical state of your property has changed. Although uniformity of assessment is not mandated by the New Brunswick Assessment Act, requiring that similar properties carry similar assessments, most of the assessors are open to reasoned argument. They are willing to amend assessments if we can demonstrate that they are incorrect.

If you would like further advice, or assistance with your appeal, please contact our New Brunswick Tax Team, André Pouliot or Rick Escott at 1-800-567-3033.

Prince Edward Island

You can expect to receive your Year 2009 Assessment Notice during the first week in May. The PEI Real Property Assessment Act provides that all real property has to be assessed at its market value on January 1^{st} of the assessment year. However the Year 2009 assessment of an owner occupied residence is computed differently. Its Year 2009 assessment is either (1) its 2007 assessment plus the assessed value of

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any improvements made after December 31^{st} 2007… provided that it was owner occupied on that date, or (2) if it was not owner occupied on December 31^{st} 2007, but was so occupied on December 31^{st} 2008, its assessment on the latter date. The 2007 and 2008 assessments are based on the December 31^{st} 2002 assessed value indexed up by the PEI Consumer Price Index to January 1^{st} 2007 and 2008 respectively. Ye gods: PEI politicians must drink from the same cup as their Nova Scotia brethren! The tax burden will therefore fall increasingly on commercial and apartment property. Although the Act mandates market value as the assessment basis for these properties, Section 29(1) requires that any appeal to the Commission must *"demonstrate the uniformity of the assessment in relationship to other assessments"* clearly implying that the market value criteria should be modified if the assessment differs from that of a similar property.

You have 90 days from the date of your Assessment Notice in which to appeal. We suggest that you utilize the following wording as your grounds of appeal:

"The assessment is excessive, unfair, not uniform with other assessments, and any other grounds that may appear."

If your property is enrolled in our PAMS™ Property Tax Manager program we will review your assessment and file an appeal where necessary. If your property is not yet PAMS™ protected, call our PEI Tax Team, Mark Turner or Rick Escott, at 1-800-567-3033. They will be pleased to help you.

Newfoundland

2009 is the third year of the tri-annual assessment cycle so your assessment

St. John's Newfoundland
($67,000 - 17% in tax savings)

should not have changed from last year unless you have demolished or added to your property. The Assessment Notices for 2010 assessment year are expected to be mailed out in September (St. John's) and 2^{nd} October (remainder of province). The Assessment Act mandates that the assessed value has to be based on the property's market value on the base date (1^{st} January 2008) but the Act contains a uniformity provision requiring that properties have to be assessed in a uniform manner with other properties in the Municipality.

LASERCAD™ DIVISION

Manulife's Challenge

Manulife had inherited, as part of its purchase of Maritime Life, a modern office campus situated in a beautiful park like setting at the head of Halifax's North West Arm. During the summer the waters of the Arm dance and sparkle in the sunlight, and are home to several yacht squadrons. In the winter the headwater, carpeted with ice and snow, is suffused with crimson by the setting sun. It is an idyllic setting. As Manulife consolidated Maritime Life's business with its own, some operations were moved to Ontario and 214,260 square feet in the four building complex became vacant. This presented a unique opportunity to the Chronicle Herald, Canada's oldest independent newspaper and the largest in the Atlantic region. The paper had embarked on a program of modernisation. It had purchased a high speed colour press and moved operations out of downtown Halifax to a new facility in the suburbs. The remainder of its staff however continued to operate out of outmoded facilities in the city centre, or were spread out in other buildings. The Manulife campus allowed them to consolidate operations and move into spanking new digs. Since the Herald were moving into several floors of one tower, Manulife needed plans showing the base building components so that the space could be tailored to their new tenant's requirements. They turned to our Lasercad™ Division for help.

Turner Drake's Approach

Manulife required accurate plans showing the location of every ceiling diffuser, light, sprinkler head, thermostat, t-bar ceiling grid, junction box, ceiling height, wall, column, corridor, washroom and elevator shaft. The 214,260 $ft.^2$ was spread over 20 different floors. Such plans as already existed were not reliable or contained insufficient detail. Our Lasercad™ team would have to start from scratch. Since construction would be ongoing during our inspections we would have to move quickly and accommodate demolition work during the six assignments. The building walls were angled so we would have to accommodate odd shaped space. We rolled up our sleeves and went to work.

Turner Drake's professional staff are university graduates, selected from the cream of the Region's business schools, who then enter a six year structured training program which carefully blends post graduate university study in real estate, in-house education and work experience. Their work is implemented, monitored and governed by a quality system registered to the ISO 9001 standard. Since a square foot of rental office space is not equal to the same amount of industrial space, the Lasercad™ team has to be familiar with the appropriate Standard Method of Measurement (BOMA, SIOR, ULI, CREA) and when to apply it. A knowledge of leases and property valuation is also important. None of our staff are over 6 ft. 4 ins. in height so accurately positioning building components that are 9 or 10 ft. above floor grade presented its own unique challenge.

The Outcome

After the first assignment, Manulife commissioned Turner Drake to complete five more assignments in the office complex. Turner Drake successfully measured the 214,620 $ft.^2$ and produced plans to the detail specified by the client, in Autocad format.

Our Lasercad™ Division provides space measurement services on office, industrial, retail and residential space throughout Atlantic Canada. Visit our web site www.turnerdrake.com or call Anish at 1-800-567-3033 (429-1811 in HRM) Ext. 324.