INVESTMENT PROPERTY: SHIFTING SANDS

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"Those who do not remember the past are condemned to repeat it"
- George Santayana

Shifting Sands

Income producing real estate matured into an alternative investment vehicle to the stock market in the United Kingdom in the 1960s. Continental Europe came of age during the 1980s. The trend gained traction in North American during the late 1970s and early 1980s. Then came the market meltdown, which occurred in Canada in 1990. This traumatic event resulted in the exit, voluntarily or by bankruptcy, of individual investors (limited partnerships, property companies), pension funds, life insurance companies, banks and trust companies. They abandoned the property market with the same fervour they had exhibited in embracing it a decade earlier. During the 1990s real estate was greeted with the type of enthusiasm normally reserved for the black plague. Then the twenty first century dawned, and everything changed (again!). Real estate became the vehicle of choice, and investors rushed back into the property market. Late last year however Banquo's ghost appeared at the feast: a chill wind started to blow as credit dried up. Property investors cast nervous looks over their shoulder at their Wunderkind. Are they correct: will we once again face market meltdown hysterics? We have been active participants in this three decade drama. In this article we explore the events which precipitated the 1990 property crash, we review its aftermath and examine the explosion of investment activity which greeted the new century. We then draw upon this experience to forecast the future. Hang on tight, the last thirty years have been a wild ride, an exotic cocktail of hope, frustration, despair, anticipation, excitement and dread. Join us on our magic carpet as we ride the winds of change through the dying days of one century into the dawn of another.

The Past Past

Following Ronald Reagan's election to the Presidency of the United States in 1980, that country embarked upon tax cuts and financial deregulation, policies designed to stimulate the economy by unleashing the country's entrepreneurial drive. Gross domestic product grew by $3,013.6 billion during that decade versus $1,751.0 billion

for the decade earlier. Much of that money was invested in real estate, particularly home ownership, following the deregulation of the Savings and Loan industry in 1982. Unfortunately lax, or non-existent underwriting standards, incompetence and fraud became the order of the day. More than 1,000 Savings and Loans Associations subsequently failed in what economist John Kenneth Galbraith called "the largest and costliest venture in public misfeasance, malfeasance and larceny of all time". Between 1986 and 1991, the number of new homes constructed dropped from 1.8 million to 1.0 million, the lowest rate since World War II. Faced with the collapse of its financial system the United States' government formed Resolution Trust in 1989 to take over the worst loans. In total the crisis cost America $160 billion, of which $124.6 billion was paid by their taxpayers. The financial crisis and the construction slowdown contributed to the 1990 recession.

American exuberance during the 1980s spilled over the border into Canada. Here the Trust Companies embarked on a program of expansion into residential real estate, often purchasing residential real estate brokers to provide a conduit for their loans. It was a marriage made in heaven, their real estate sales brokerage company reaped the commission on the houses they sold, and had ready access to mortgage funds to facilitate their sales. Their parent had a captive market for its loans. Nor did the Trust Companies confine their activities to residential mortgages: they enthusiastically competed with the banks and life companies to place commercial mortgages. In one infamous case, a property company called Cadillac Fairview sold 11,000 rental units in Toronto to Greymac Credit Corporation for $270 million: they immediately flipped them to Kilderkin Investments Ltd. for $312.50 million...who promptly "resold" them to 50 numbered companies for $500 million. $152 million of financing was provided by a triumvate of trust companies: Crown, Seaway and Greymac (there was an existing first mortgage of $110 million when Cadillac Fairview sold the property and they supplied a vendor take back mortgage of $113 million). The owner of the trust companies and the mortgagors involved in the $152 million flip financing were related parties. Ironically the alarm was raised by the tenants, afraid their rents were going to increase; rather than by the trust companies' depositors. The Provincial and Federal Governments stepped in to protect the depositors. By the Fall of 1987 our Newsletter was resignedly reporting that "yet another Trust Company has gone bankrupt", and by the end of the decade trust companies that had been household names for decades had failed financially or had been absorbed by the major banks: the trust company industry as an independent entity had effectively disappeared. The stage was set for the 1990 property collapse.

We pinpoint May 1990 as the start of the real estate recession in Atlantic Canada, based on the reduction in sales volume and prices in the residential property market. (We've tracked this activity continuously since 1978). In reality however the commercial property markets started to feel the pinch in 1989 as credit dried up. This however was a worldwide phenomenon whose triggering event lay far offshore in Thailand. The baht, the country's currency, collapsed as a result of over exuberant property loans by its banks; the contagion spread to Japan, whose banks had exhibited similar malaise, and then around the world. Professors Richard Herring and Susan Wachter of the Wharton School, University of Pennsylvania produced a research paper in 1998 on the Asian Twin Financial Crisis. In it they noted that "one striking feature of the current Asian financial crisis is that the most seriously affected countries *first* experienced a collapse in property prices and a consequent weakening of their banking systems *before* experiencing an exchange rate crisis". (The dependence of the national economy on the banking system is acute in emerging nations since their banks hold over 80% of the total assets; or in present day Japan where they hold 79%, according to the good professors).

The Wharton study looked at real estate busts and bank crises in Sweden, the United States, Australia, Japan and Thailand. It found that while they can occur independently of each other, a collapse in property values is due to (1) a sharp fall in demand, or (2) a rapid rise in supply or (3) both of the foregoing. The study's authors found that the prime culprit was a rapid rise in supply fuelled by easy credit from the banking system, which continued long after rising vacancy rates should have signalled an over expansion.

The commercial property market collapse in Atlantic Canada in 1990 was no minor event. Hotels/Motels throughout the Region plunged in value, on average, by 50%. Industrial properties lost between 25% to 75% (average 44%) of their value if they were situated in Burnside, the region's largest park, located in Dartmouth, Nova Scotia. In Nova Scotia, the further one moved away from the Halifax/Dartmouth area, the greater the drop in value. Industrial properties located in places such as Amherst lost between 50% and 80% of their value. The office sector in Halifax Central Business District was devastated, losing about 55% of its value. The apartment market dropped 5% to 10% on Halifax Peninsula, 50% in Dartmouth's Highfield Park, and 30% to 50% elsewhere in Metro. Retail, shuddering under the twin impact of the recession and the growth in "big box" merchandising, also suffered badly. Some Shopping Centres fell in value by 35% (Neighbourhood) to 55% (Community). All this in a Region where, for at least thirty years, (and probably since the Great Depression) property prices had steadily increased, year after

year. The banks ran for cover, investors felt betrayed, we questioned whether there was a God… and saved property owners millions of dollars in successful tax appeals.

The Lost Decade (1990-1999)

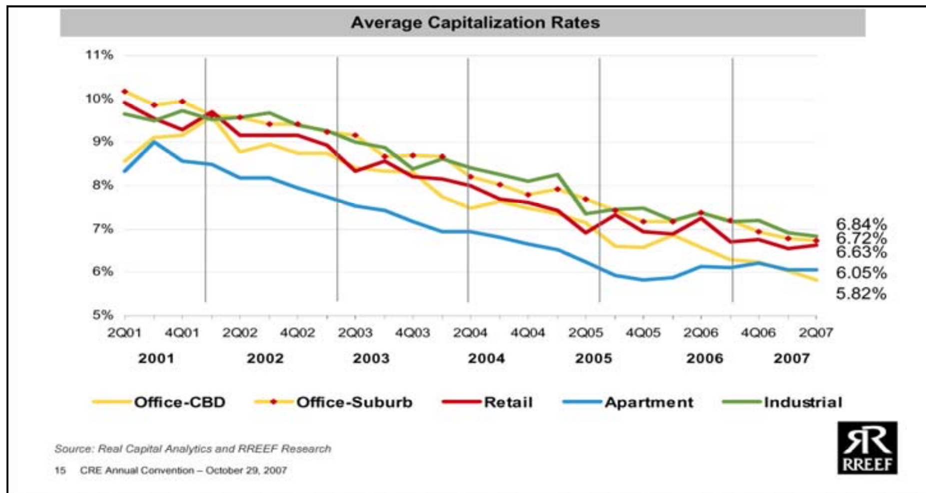
The market meltdown which hit Atlantic Canada in May 1990 was not immediately apparent. Until 2009 sales information was not public knowledge in the three Maritime Provinces (Nova Scotia still jealously hoards it), and the Newfoundland registry office is such a mess, effectively there is none there either. 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 below:



Source: Real Capital Analytics and RREEF Research, October 2007.
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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 mattresses. 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.

The 1990 recession lasted for two years: GDP dropped by 3.2% in the first year; growth was almost non 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.