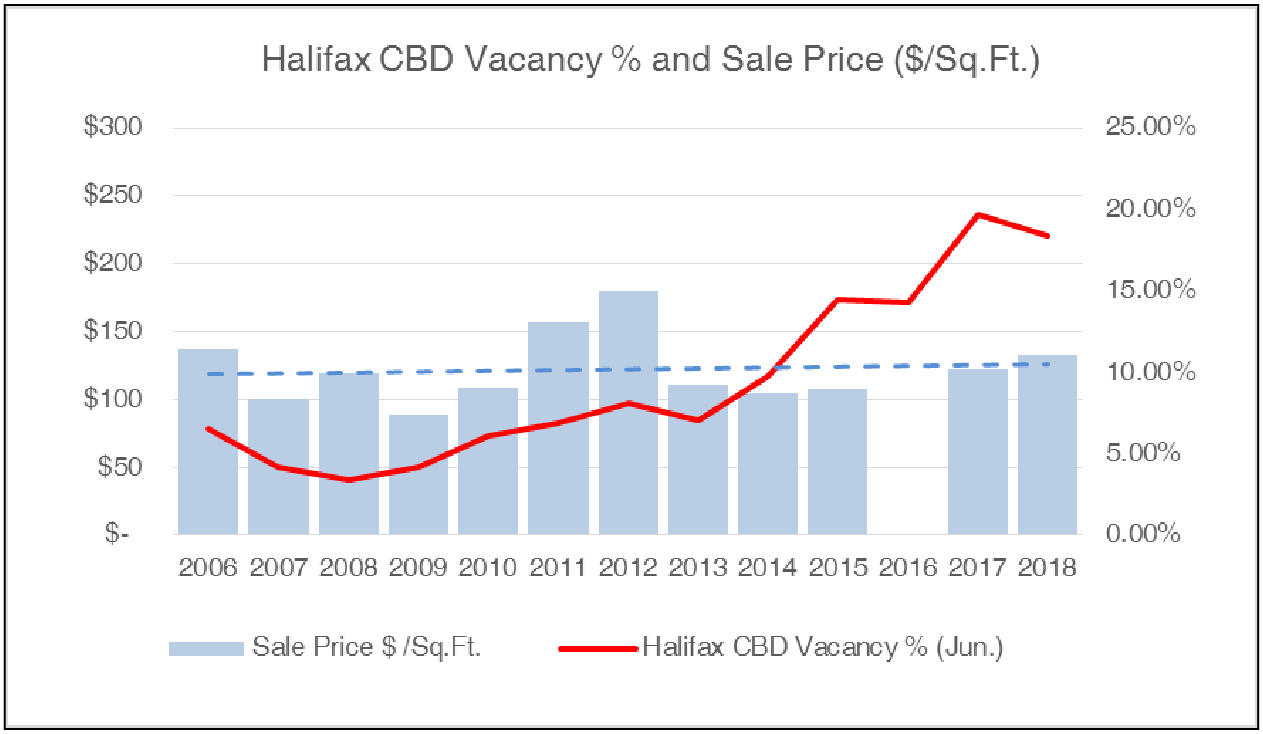
PROPERTY VALUATION - MAXIMISE VALUE: MINIMISE RISK



Source: TDP Economic Intelligence Unit

Property owners can draw on the expertise of a valuation profession in many developed countries, but such a resource has yet to mature in Canada. Instead there are a multiplicity of organisations, each of which focus on *part* of the real estate spectrum: brokerage, appraisal, property tax agency, space measurement, right of way acquisition, planning, economic research, et al. Provincial licencing may further muddy the water because it follows the same fractures: since it obfuscates rather than illuminates, it may forestall due diligence; less knowledgeable purchasers of property advice may be willing to accept licencing as a proxy for professionalism in all matters real estate related. More knowledgeable consumers may cynically attribute the lack of expertise in a particular field as being emblematic of all licensees in other fields too.

The absence of a valuation professional body is echoed in the lack of research at university level. This paucity of research renders property investment in Canada a relatively risky exercise particularly since it leads to municipal and regional government policies which are frequently counterproductive. During the four decades we have been active in Atlantic Canada we have witnessed numerous real estate markets decimated by ill-advised and reckless government programs seemingly driven by whatever the politicians or bureaucrats deemed advisable "at the time", without any research or consideration of the consequences: call centres, conference centres, golf courses, heavy water plants, hotels/motels, hydro plants, industrial parks, industrial buildings, marinas, nuclear plants, oil refineries, shopping centres, steel mills, and most recently the flooded office market in Halifax's Central Business District, have all fallen victim to a rapid expansion in supply fuelled by government grants or policies which favour a specific market segment. The grants and policies are usually motivated by the conviction that they will spur employment; that public participation is necessary to combat private sector inertia. Chasing dreams at all levels (Federal, Provincial, Municipal) is a political preoccupation in the Atlantic Region.

Given that there is no national professional valuation institute, little university research, government action predicated on short term objectives, an appraisal industry mandated to measure value rather than create it: how can you maximise value and minimise risk in the ownership of your real estate?

Which Value?

If you wish to determine the value of your property, establishing "which value" is the essential first step in all assignments. It is a common misconception that every commercial property has a single value. Not so! Yet we are frequently asked by professionals, such as accountants and lawyers, as well as real estate owners, what it will cost to appraise a (specified) property. The International Valuation Standards (IVS), adopted by Canada, and incorporated into the Royal Institution of Chartered Surveyors' Global Valuation Standards, specify *six types of real estate value (Market, Rental, Equitable, Investment, Synergistic, and Liquidation).* Legislation, case law and the purpose of the real estate assignment, result in many variations of these property valuation bases. Any conversation about valuing (or appraising) your property has to start therefore with an understanding of the purpose of the assignment or you can end up with a conclusion which is worthless at best, or seriously misleading at worst. Whilst the common assumption appears wedded to the concept of Market Value *assuming that the property will be utilised for its highest and best use* … this basis is not acceptable for mortgage financing, if for example, the highest and best use is predicated on redeveloping or repositioning the property for an alternate use. Nor may it be relevant if the property's existing use is special-purpose and/or trade related with a limited number of potential purchasers e.g. fish plant, meat packing plant, hotel, service station, etc., even if the existing use is the highest and best use, unless the financing is based on the value of the asset as part of a going concern. Nor is Market Value appropriate if the purpose of the valuation is to determine the price for liquidation (under conditions of forced sale), a sale to an adjoining owner, a land assembly, for an identified investor, or between identified willing parties. Determining the correct ***valuation premise*** and the ***level of real estate reporting*** necessary to satisfy the end user of the valuation and advisory report is a precondition to any valuation (or appraisal) assignment.

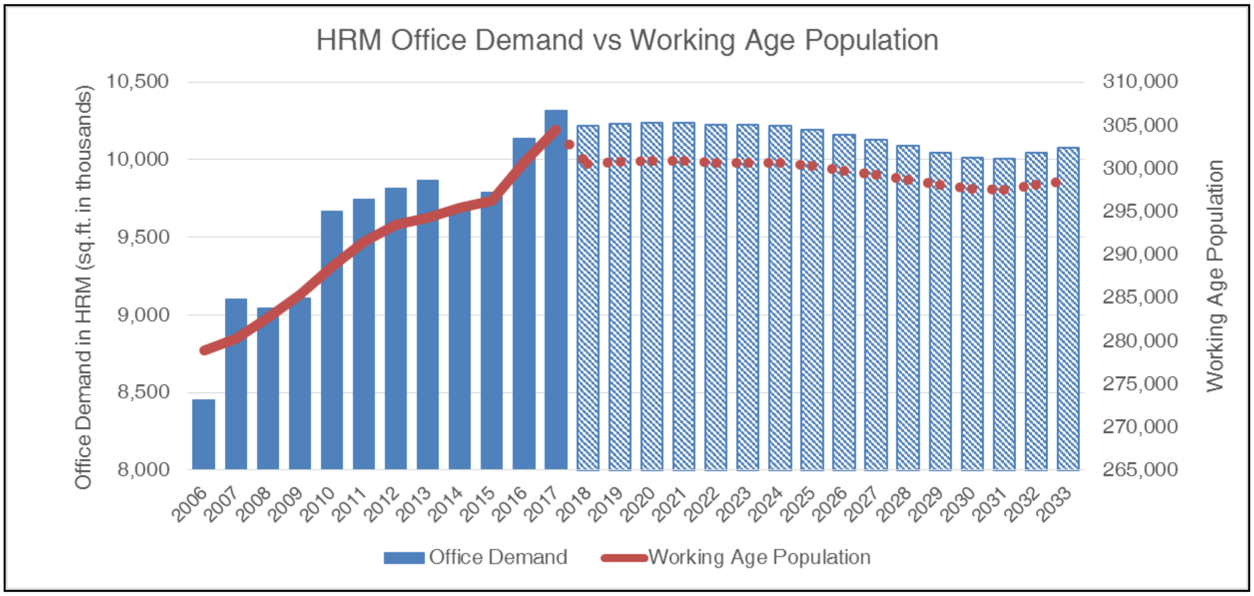
Adding Value

Valuation tasks fall into one of two groups: **adversarial** or **non-adversarial**. Both situations present different opportunities for adding value to the assignment.

Adversarial assignments can rapidly escalate into a costly, time consuming and frustrating legal exercise. Your prime objective therefore should be to seek a solution which avoids litigation and an expensive court action. This can only be achieved by an open, consultative and transparent process involving all parties, thorough research, and a well-documented valuation report with a fully supported, unbiased conclusion, the rationale for which is technically and legally valid but easily understood by a non-technical reader.

Non-adversarial assignments provide many opportunities to add value to your real estate even when the purpose of the assignment is directed to a single goal, for example establishing Market Value for financing purposes. Our Valuation Team are trained to recognise and identify opportunities to enhance or safeguard the short and long term prospects for your property and can call upon the expertise of our other Divisions (Property Tax, Planning, Lasercad® Space Measurement, Counselling, Economic Intelligence, Brokerage) for advice if such is required. For example, there may be opportunities to reduce the property taxes, to "up zone" or prevent a "down zoning", increase the "BOMA" leasable area, restructure the leases, increase the rents, reduce operating costs, or make cosmetic changes which would enhance marketability and value.

Market Data Drives Property Values. It is fallacious to assume that a real estate professional can provide you with useful advice based purely on experience. The answers lie in the data. The availability of real estate sale prices, property assessments, rents, vacancy rates, operating expenses (common area maintenance & property taxes), building costs, financing, on comparable properties together with the tools to integrate this data, determine and analyse trends on a cross sectional and longitudinal (time series) basis, is the key to uncovering latent value in your property. It allows us to compare operating metrics such as rent, vacancy, operating expenses (property taxes, HVAC, electricity, cleaning, insurance, water, repairs, elevator maintenance, garbage removal, security, landscaping, snow removal, supplies, professional fees, advertising, management) with comparable properties on a unitised basis to determine opportunities for increasing revenue or reducing costs. We can also establish the trend line for each of those items, for your property and its peer group, to determine where you are headed and how your property will be positioned vis à vis its competitors. CompuVal®, our proprietary IT platform, provides a comprehensive picture of property sales and assessments for Atlantic Canada and Ontario. Our Economic Intelligence Team conducts semi-annual market surveys on office and industrial buildings gathering commercial property rental, operating expense, property tax and vacancy data. They also undertake apartment and parking revenue and expense surveys throughout the Region. Our Property Tax Team collects a vast amount of operating data on many property types. The three Maritime Provincial governments now feed raw sales information to our data processing department every month. Because the data is sparse, dirty and defective we have armed CompuVal® with clever algorithms to clean and enhance it. CompuVal® acquires, processes, refines, integrates and analyses all of the sales and operating revenue and expense data. Our data processing staff further enhance the data using our Geographic Information System's high resolution aerial and satellite photography.



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The bottom line? On the micro level we can identify areas for increasing revenue or determine if the opportunity exists to reduce any of your operating costs. You probably undertake this exercise every year when formulating your property budgets by reviewing past costs for the same property or comparing it with others in your portfolio. Our Valuation Team does so too, but CompuVal® provides them with ready access to detailed revenue and expense data on a universe of comparable properties to assist them identify value adding opportunities for your real estate. At the macro level CompuVal® runs trend line analysis on revenue, operating expenses, capitalisation rates and unitised sale prices to investigate past trends and predict what will happen in the future. We use research generated by our Economic Intelligence Unit to inform our valuation advice.

The End Result

What advice could our Valuation Team provide if you own an office building in Halifax's Central Business District (CBD) for example? We would compare your revenue, vacancy, and each operating expense against previous years and also with your building's peers to determine if there are opportunities to increase revenue, reduce vacancy and expenses. The bigger question however is where those metrics are headed. As the Halifax CBD Vacancy graph on demonstrates, office vacancy started to climb steeply in 2013 and is now at 18.35% (June 2018), the consequence of oversupply in a market experiencing generally weak occupier demand. Aggregate CBD office demand has now been virtually stagnant for the past twelve years. "Same store" net absolute rents are now starting to decline so we would advise you to lock in your tenants long term. This should be a priority given that the national inflation rate continues to hover around the 2% mark and net absolute rents will continue to fall. Capital values, expressed as a sale price per square foot of office space have been stable over the past 12 years (see Page 1 graph). *During the last market meltdown in 1990, which started when the onset of a recession coincided with a rapid expansion in office supply, office capital values fell by about 55%. The fall in value was not apparent for two or three years because property owners declined to sell, possibly because the amount they could realise on sale left them with no or negative equity after the mortgage was satisfied and/or they were hoping for a turnaround*. As office values fall so should property assessments: you should therefore adopt an aggressive strategy and appeal your property assessment each year. (Realty taxes per square foot have risen by 60% over the past ten years; net absolute rents by just 12%. This is your opportunity to redress that balance). Tenants will move up the value chain to take advantage of the falling rents… Class C to Class B, Class B to Class A. Given that there is a strong demand for rental apartments some Class C and B buildings will be redeveloped or repurposed for residential use and this will ameliorate the vacancy rate. However this will be a slow process because buildings have leases in place, some owners are commercial investors rather than residential developers, and there will be a natural reluctance to "hang on and hope". *How long will it be before supply and demand is in equilibrium and office vacancy returns to a "normal" 5%? It depends how fast buildings are taken out of service… or on the emergence of those offshore financiers coyly closeted in the fog bank at the mouth of the harbour! Our guess is about 20 years: office vacancy took 14 years to fall from its previous high of 16.2% in 1992; it did not reach equilibrium 5.19% until December 2006.* During that period only one small office building was completed and the working age population was growing. Currently Queens Marque is under construction and will add a further 120,000 $ft.^2$ of office space to an already flooded market; working age population peaked in 2017 and is now declining. There is a high correlation between office demand and working age population (see HRM Office Demand vs Working Age Population graph on Page 2). Post 2017 therefore, reduction in office vacancy will be a function of diminished supply rather than increased demand. If your office building is a Class B or C and it, or the site, is suitable for residential use you may wish to take advantage of the current strong demand for rental apartments by repurposing the building or redeveloping the land … or by selling the property.