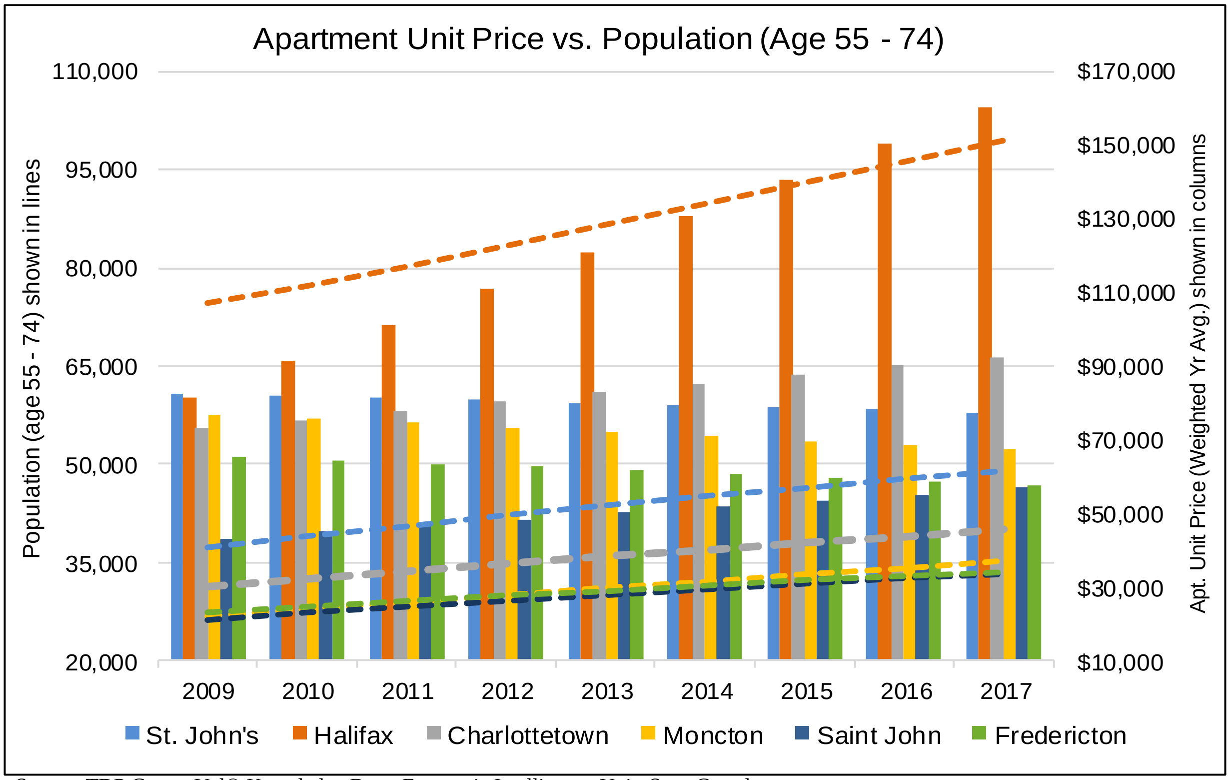
APARTMENTS: A GOLDEN AGE



Source: TDP CompuVal® Knowledge Base, Economic Intelligence Unit; Stats Canada.

Property markets throughout the Region are on a roll! Scarcely a week goes by without news of another investor new to Atlantic Canada, determined to join the party. In earlier times the ocean's rich bounty drew entrepreneurs here: fish, fowl, Spanish treasure, buccaneering, rum running, oil and gas, all had their place in the sun. Some linger still: plundering promises substantial reward. Property booms here however are rarely propelled by Regional activity, rather they are the result of events elsewhere, and so end badly. Although the relatively recent property market boom in St. John's was triggered by the success of the Province's offshore oil and gas activity, the exploration was itself a function of soaring energy prices on the world stage. Following the collapse of oil prices, the City of St. John's was left with a surfeit of office space. The local economy continues to follow the fortunes of oil prices elsewhere. The Atlantic Region's first post war property boom was fueled by a surplus of money seeking a home, coupled with a dearth of investment opportunity elsewhere. Launched in the late seventies, it peaked in the late eighties, crashed and burned in the early 1990's, at which point some property had a negative value. The feeding frenzy which fed that property boom was amplified by national and international players: property companies, institutional investors (pension plans, life insurance companies) and limited partnerships (the predecessor of today's Real Estate Investment Trust). This incremental demand, added to that of local investors, drove up property prices, values that had hitherto been determined by purchasers knowledgeable of local conditions and risk. The ex parte investors acquired properties based on their knowledge of opportunities elsewhere and critically under estimated the risk involved and therefore the commensurate return required, to operate property in this Region. When the Thai baht collapsed, the result of the failure of that country's banks, the contagion spread rapidly around the world. When it reached our shores in August 1990 the financial institutions headed for the hills and withdrew credit. The ex parte investors experienced an epiphany and unloaded their property investments with the same alacrity exhibited a few years earlier in purchasing them. They dumped properties into a market bereft of mortgage availability. Those of us then active in providing real estate advice experienced an emotion akin to that of a priest who discovers there is no God. We are now in the second post war property boom: it is eerily and disturbingly similar to the first. The brunt of the 1990's crisis was borne by the Region's locally based investors; few survived. Time to take stock!

Banking on the Boom

Investment activity is mixed but by and large apartments are the favoured regional investment, appealing to a wide spectrum of buyers, from local to international investors. This is partly due to the fact that the buildings come in a broad range of sizes, management requirement and expertise, as well as price. They are also less risky than other property types. Suite sizes are smaller than other investment opportunities so the loss of a single tenant is less catastrophic. But it is also due to the fact that other property type investments are struggling. Office and Industrial properties in particular, are having a hard time: there is a surplus of space in every one of the six Census Metropolitan Areas and Census Areas we survey. Our Economic Intelligence Unit surveys the entire universe of office and industrial properties available for rent in buildings 5,000 ft.^{2} and larger. Our June 2018 study covered office space in every metropolitan area together with industrial space in HRM. The remaining data is taken from our December 2017 survey. As the table shows, vacancy is well above the equilibrium 5% for both property types in all areas.

CMA-CA	Office		Industrial	
	Vacancy	Trend	Vacancy	Trend
St. John's	21.00%	Rising	11.34%	Falling
HRM	15.44%	Rising	11.84%	Falling
Charlottetown	13.05%	Falling	10.63%	Falling
Moncton	12.10%	Falling	22.66%	Rising
Saint John	18.95%	Falling	11.88%	Falling
Fredericton	9.70%	Falling	18.97%	Rising

Source: TDP Economic Intelligence Unit

The high office vacancy in St. John's is due to the collapse of oil prices following an over enthusiastic expansion of supply predicated on the assumption that such would not occur. Sadly it did, but oil prices are rising again and the vacancy rate will eventually fall. The high office vacancy in the Halifax Regional Municipality (HRM) is due, in large part, to an over expansion of supply triggered by government grants, apparently based on the conviction that this was necessary to transform Halifax's Central Business District into a New York style financial centre. At the time the decision was taken it was believed that the financiers were camped off the harbour's mouth waiting for their rooms to be prepared. Unfortunately they have yet to materialise; lost in the fog bank perhaps?

Industrial demand is driven by changing materials handling technology. Over the past forty years building ceiling heights have increased decade over decade substituting cubic capacity for floor area. Building structures have a physical life of between 40 and 50 years. They are not subject to the same economic pressures from increasing land values if they are located in an industrial park so there is less incentive to redevelop than would be the case if they were located in a more urban environment such as the Central Business District or on a heavily trafficked highway. Functional obsolescence due to the desirability for higher ceiling heights does not impose the same redevelopment time sensitive pressure either as increased land value. Functionally obsolete industrial buildings therefore tend to hang around, bloating supply and increasing the vacancy rate. During the past 17 years Fredericton has never achieved supply/demand equilibrium; St. John's, HRM and Saint John last reached it in 2005, Charlottetown in 2010 and Moncton in 2011. Now that we have a declining working age population, high vacancy rates are destined to become a fixture of the industrial landscape … new buildings will capture the demand.

Over the past three years there has been a strong demand for hotels in St. John's and the Halifax Regional Municipality confounding Airbnb enthusiasts. We suspect that demand might have peaked now, but in any event hotels are a specialist investment. Shopping centres too may be past their prime as an investment given the competition from on line shopping unless they are a Retail (Big Box) Park, a Regional Centre that still commands the heights in its market, a Neighbourhood Centre or Strip Mall servicing a neighbourhood or busy highway. Community Shopping Centres are a fading force; most have attempted to respond by reverting back to strip centres from enclosed malls.

Apartments: Investment of Choice

Given the foregoing it is little wonder that apartments appeal to the greatest range of purchasers and that for many, are their retirement nest egg. They promise to grow their investor's initial equity investment by mortgage principle pay down and capital appreciation, as well as providing some return on the investment itself … and they minimise income tax, a major consideration given this country's punitive tax regime which finds its apogee here in Atlantic Canada.

The ability to tax shelter a cash throw off (the revenue remaining after deducting operating expenses and debt service from gross income) and the mortgage (principle) paydown, by utilising the capital cost allowance (CCA) is attractive to owners attempting to build their retirement nest egg. However CCA will decline every year post purchase since it represents the depreciation allowed on the building and other improvements based on their acquisition price. Canada Revenue Agency will also claw it back when the property is sold. However income tax payable on capital gain, the increase in value of the property since purchase, realisable on sale, will only be taxed at 50%. This capital gains tax liability together with capital cost allowance recapture can be deferred by postponing the property sale and remortgaging instead, to release capital. Property appreciation therefore is key: real estate that falls in value appeals only to masochists, stability in value to socialists, increasing in value to realists. If you fall within the last camp, where should you have entrusted your hard earned dollars and what guideposts can you utilize for the future? We are about to tell you: but first …

The Magic of Appreciation …

… and Financial Leverage. Imagine the following scenarios. You remortgage the family home, pledge your first born, promise your daughter's (or son's) hand in marriage, sell the dog, prevail on your parents, lie to your bank and acquire a relatively new apartment property for $3.0 million. That sum will buy you a 15 unit building in Halifax's South End; double that number of units in less refined locations elsewhere. You persuade your bank to provide a mortgage for 70% of the purchase price for a 10 year term, 25 year amortization, at 4% per annum. Life looks good: you settle down to a decade of bed bugs, cockroaches, failed furnaces, leaks and things that go bump in the night. Over the next ten years your property does one of two things: it does not increase in value (the socialist within you is satisfied) or its value increases by a modest 3% per year. How will your initial $900,000 equity grow over the next ten years and what will it be worth in today's dollars assuming annual inflation of 2% …

	At Date of Purchase	After 10 Years	
		No Increase	3% Annual Increase
Market Value	$ 3,000,000	$ 3,000,000	$ 4,031,749
Mortgage Balance	$ 2,100,000	$ 1,496,728	$ 1,496,728
Equity	$ 900,000	$ 1,503,272	$ 2,535,021
		$ 900,000	$ 900,000
Equity Increase (2018 $)		$ 603,272	$ 1,635,021
Deflated @ 2% pa.		x 0.82	x 0.82
Equity Increase (2018 $)		$ 494,893	$ 1,341,287

A caveat: Canada Revenue Agency will treat your mortgage principle pay down plus any cash throw off, as taxable income to the degree that it is not sheltered by your capital cost allowance. Still, on a gross income basis you are better off ten years' hence to the tune of an extra $1,031,749 ($846,394 expressed in today's dollars), if the property appreciates in value.

Quo Vadis?

We have analysed the sale prices of apartment properties in all six major metropolitan areas in Atlantic Canada for the time span January 1st 2009 to September 25th 2018, utilising our proprietary CompuVal® Knowledge Base. Each sale was analysed on a "unit basis" i.e. the price was divided by the number of apartments in the building. CompuVal® then calculated the weighted average price each year and ran a regression line through them to produce a "predicted" average unit price. The result is displayed in the bar chart on Page 1. Over the past nine years apartment prices have, on average declined slightly in St. John's, somewhat in Moncton and Fredericton, increased moderately in Charlottetown and Saint John, and substantially in Halifax Regional Municipality. Unfortunately the past is … well passed, so where do you purchase in the future? Our Economic Intelligence Unit (EIU) married our CompuVal® analysis with demographic data from Statistics Canada to produce the answer.

The demand driver for rental apartments is population growth or decline. Our EIU investigated the two demographics that are the largest users of rental accommodation, the 20 to 29 year olds and the "empty nester" 55 to 74 age bracket. The younger age group explains about 80% of the price differential in apartment building prices in Halifax and Charlottetown, presumably reflecting the influence of their respective universities' populations, but had little to moderate influence elsewhere. The empty nester cohort on the other hand had a greater influence on apartment prices. It consistently explained most of the price differential in each of the six municipalities. The 55 to 74 age cohort is represented by the dash lines in the graph on Page 1.

The Conclusion

If you are going to purchase an apartment building choose a location with a growing empty nester (55 to 75 age cohort) population. A younger demographic (20 to 29 age cohort) is a bonus if it is growing but is location specific proximate to a university, hospital or similar institution.