TURNER DRAKE & PARTNERS

Real Estate Counsellors,
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TRENDS

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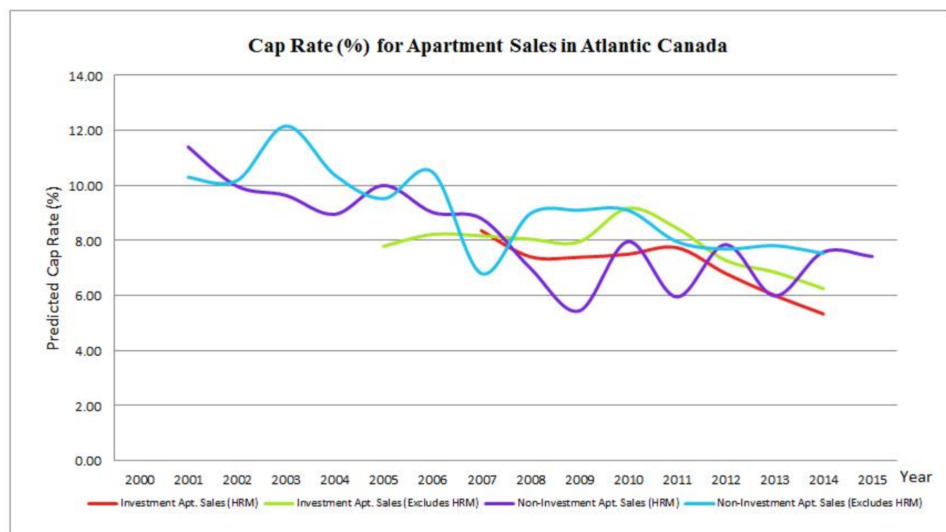
Subject: Apartment Prices Peaked?

Comments: The overall Capitalisation Rate (the "Cap Rate" to real, real estate men . . . and women) is the most frequently cited gauge of property performance, partly no doubt to capture some of the glamour accorded its stock market sibling, the Profits Earnings (P/E) ratio. The Cap Rate (technically "R") is computed by dividing the property's Year 1 Net Operating Income (NOI) by its Sale Price, and is expressed as a percentage. The weakness will be immediately apparent to discerning readers: it fails to reflect changes in the NOI over the investment holding period. Despite this illogicality, our own research clearly indicates that investors and their financiers favour it over more inclusive measures such as the internal rate of return (IRR). It is most frequently cited by leading commercial brokers who, with reassuring pomposity, gild their gravitas with elaborate quarterly brochures purporting to invest the humble Cap Rate with a precision it lacks in life, by ascribing ranges that vary by as little as 0.5% within each asset class. While hugely entertaining, such "studies" are almost completely fictional. There are insufficient sales in any quarter for any asset class, to produce a meaningful result even in Atlantic Canada's largest city. Indeed there are often no sales of a particular asset class at all. Whilst *average* Cap Rates are not a useful tool to value specific property they can be utilised to determine market value trends. However in order to assemble data sets with any validity it is necessary to aggregate information on an annual basis and occasionally to interpolate for intervening years where reliable sales data does not exist. Because sales data is sparse in some years, and abundant in others, we usually rely on the median, rather than the mean, as our measure of central tendency and use an exponential smoothing average to neutralise outliers. When the NOI is stable, a situation pertaining to apartments in most areas of the Atlantic Region today, property values fluctuate inversely with changes in the Cap Rate. A falling Cap Rate signals market values are rising and vice versa.



The graph shows the Cap Rate for apartment buildings disaggregated into four sub-markets based on type (Investment Grade, Non-Investment Grade) and location (HRM, Elsewhere). Investment Grade real estate is typically held by the REITS (real estate investment trusts), pension funds et al. The buildings usually contain 50 or more units, or comprise a portfolio of similar size in the same neighbourhood. They are modern and well located in one of the Region's six largest metropolitan areas. Non-Investment Grade Apartments comprise the remainder.

Investment Grade Apartment buildings had stabilised in value prior to 2009 (outside HRM) and 2011 (HRM). They briefly fell in value the following year but recovered and started to increase again. The raw (unsmoothed) data indicates that prices stabilised again in 2013. Market price movements are influenced by the cost and availability of mortgage financing. It is difficult to see how mortgage rates can decline further so market values have probably peaked. They will decline in value if mortgage rates rise, unless rentable rates recover from their present hiatus.

Non-Investment Grade Apartments have fluctuated in value but the predominant trend has been upwards until 2007 (outside HRM) and 2009 (HRM). The raw data indicates that prices started to fall in 2012 (HRM) and 2013 (outside HRM). We suspect that the decline in value will continue as mortgage rates rise unless rental rates recover from their present hiatus.

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