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TRENDS

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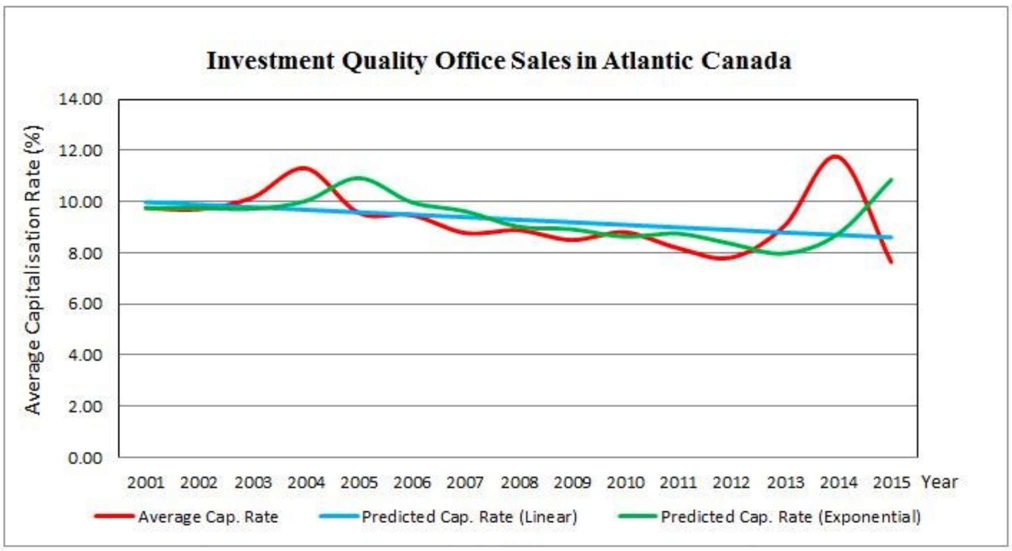
Subject: Investment Grade Office Properties.

Comments: Determining property price trends in Atlantic Canada is a little trickier than may first appear. At first blush the most reliable evidence of a shift in market value would be the sale and resale of the same properties, or very similar properties, in sufficient quantity to neutralise the impact of outliers. However there are insufficient transactions to provide year over year comparison even if such data was publicly available. Unfortunately the four provincial governments control data access and they only release sparse details … reluctantly. Apparently they fear that full disclosure would unleash a flood of property tax appeals (the legislated basis for property assessment is "market value"). We devote three full time equivalent research and data processing personnel plus a programmer, and have an eye watering investment in clever software, to acquire, parse, process and analyse sales, income and expense data. Despite the fact that our various Divisions get close up and personal with billions of dollars worth of clients' property each year, we are still data deprived. Take office properties as an example. The most obvious index, sales price/ft.^{2} is unreliable as a price trend indicator because lower prices may simply reflect a shift in building quality, based on availability rather than buyer preference. In fact values may be increasing while price/ft.^{2} falls because owners refuse to sell their Class A buildings, forcing purchasers to acquire available Class B stock. In previous issues of TDP Trends we utilised the Overall Capitalisation Rate (R) as our price trend indicator. The overall Capitalisation Rate is the product of dividing the Year 1 Net Operating Income (NOI) by the Sale Price, expressed as a percentage. It does not capture changes in the NOI over the investment holding period, but it does reflect risk. A rising Cap Rate therefore signals falling property values. However, the challenge is to acquire sufficient sales data in a Region with a population of only 2.4 million, one third of whom still live in the countryside. While several real estate brokerages do publish quarterly Cap Rate "surveys", they are works of fiction, suitable for name dropping at a party but not to be taken too seriously. (They frequently ascribe values to asset classes for which there are no sales transactions). The following graph illustrates the problem:



Is the 2013 and 2014 data an anomaly … or is 2015 the outlier? Are cap rates falling (and prices increasing) as predicted by the blue linear regression line … or rising (and prices falling) as suggested by the green exponential smoothing average? In reality Cap Rates do not fall within the narrow 0.5% band beloved by the brokerage surveys. Risk is a function of the tenant covenant, competition from other properties, the proportion of space occupied by a single tenant and a multitude of property specific factors. Atlantic Canada markets are very shallow and tenants tend to be large and few … or very small and many. A new building, or the exit of a large tenant, will cause a major shift in supply and demand. Even Halifax with the region's largest Central Business District, is hostage to such events with a concomitant impact on office vacancy rates. An "average" capitalisation rate of 7.50% reflects a data range of 7.0% to 9.0%. In a low sales volume market the average cap rate is easily skewed by outliers. A more nuanced analysis is therefore required.

Time to man the lifeboat? Absolutely … and definitely not! It depends on the type of office building, the city and sometimes neighbourhood in which it is located.

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