Benefits and Pensions MONITOR Meetings & Events WEBINAR

FIERA REAL ESTATE

Real Estate Valuations - Drivers and Trends

The *Benefits & Pensions Monitor*, "Real Estate Valuations - Drivers and Trends" – sponsored by Fiera Real Estate brought together Aline Santos, Manager of Valuations and Asset Management at Fiera Real Estate, Michael Le Coche, Director, Strategy and Research at Fiera Real Estate and Ken MacIntyre, Vice President of National Accounts Research Valuation and Advisory for Altus Group; with Greg Martin, Vice President, Strategy Planning and Analytics at Fiera Real Estate moderating.

The experts provide a comprehensive overview of the current real estate valuation trends and placing the recent downward pressures on real estate valuations into historical perspective. This context is crucial for understanding how current trends compare to past cycles and what unique factors are influencing the current market.

How is this current real estate valuation cycle different from a typical cycle?

MacIntyre: This current economic downturn presents unique characteristics. It shares some similarities with the 2008-2009 period, such as the decrease in property values and the widening gap between what buyers are willing to pay and sellers' expectations. However, there are notable differences.

Back then, interest rates were decreasing, whereas they are rising now. Currently, market fundamentals are generally stronger across various asset classes, except for office properties, a sector now grappling with remote work policies. Another distinction is the current scarcity of capital availability and the absence of significant deals. Many assets are complicated ("have some hair"), and there's a notable lack of comparable transactions. The few deals that do occur often come with unique stories or potential future uses.

There is also a variance in the behavior of different property types during this economic cycle. Unlike in previous downturns, simply waiting for the market to recover may not rectify investment mistakes in this cycle.

What do you see as the main drivers of this downward pressure cycle?

Santos: The most significant value declines have been observed in the office sector, with about 80% of these declines attributed to yield impacts. The path for office valuation is increasingly affected by cash flow issues, a consequence of changing work habits and remote work policies.

The industrial sector shows a stark contrast to the office sector. Although it has experienced substantial value fluctuations, these are more than compensated for by strong rental growth. The industrial sector's resilience and growth are notable, especially in the context of the current economic climate.

In the multi-residential sector, there's a similar pattern of rental and yield growth, but at a lower magnitude compared to the industrial sector. This sector shows less alignment in terms of stabilizing cash flow, particularly when compared to fully leased, triple net industrial assets. This has led to a more cautious approach in valuations for multi-residential properties.

The year-over-year decline in retail property values is mainly driven by increased yields. The impact varies significantly depending on the type of retail property. Enclosed malls have seen greater value declines compared to grocery-anchored shopping centers, reflecting changes in consumer behavior and shopping preferences.

In terms of regional performance, for the apartment sector, positive variances have been observed in Calgary, the Greater Toronto Area (GTA), and the Atlantic regions. The industrial sector shows positive year-over-year increases across the board, with especially high variances in Vancouver, Montreal, and the Atlantic regions. In the office sector, the trends are as expected, with no specific regional variances highlighted.

> "IN CANADA, THERE IS MORE CONCENTRATED OWNERSHIP OF REAL ESTATE. INSTITUTIONS WITH STRONG FINANCIAL BACKING ARE BETTER POSITIONED TO HOLD ONTO THEIR ASSETS DURING TOUGH TIMES, REDUCING THE NEED TO SELL IN A SOFT MARKET."
>
> -KEN MACINTYRE

From more of a macroeconomic perspective, what do you see is driving these negative values?

Le Coche: When you think about the key drivers of any investment that you're making, you want to think about what's going to affect the future performance. The primary questions to ask yourself are; one, will the cash flows grow over time? and two, is there enough liquidity or availability of capital to expand the valuation multiple that is applied to that cashflow?

Growth in cash flow here refers to macro-economic growth relative to its potential, which can affect the net operating income (NOI) of real estate. This factor is crucial for predicting the future profitability and viability of a real estate investment.

The liquidity or availability of capital pertains to the availability and cost of debt capital or mortgage financing, which is especially important in real estate. Liquidity influences the evaluation of the multiple applied to the cash flow, determining how much investors are willing to pay for a given level of income.

Using proprietary indicators to track these factors, it is possible to measure the rate of change in growth and liquidity cycles. These cycles can be plotted and segmented into four phases: recovery, expansion, peak, and contraction. This segmentation helps in forecasting the future of real estate, which typically responds with a slight lag to economic changes.

For instance, the onset of the pandemic in first quarter 2020 marked a severe drop in growth, placing the market in the contraction quadrant. However, subsequent quarters showed improvement as the economy reopened and fiscal and monetary policies bridged the liquidity gap. This led to a sharp recovery in growth and liquidity, preventing the distress in commercial real estate that many had anticipated.

By mid-2020, the market moved into the expansion quadrant, but by the fourth quarter of 2021, it approached the peak of the cycle, leading to a cautious approach by the first quarter of 2022. Around this time, inflation began accelerating, and Central Banks signaled tighter credit conditions, contributing to a contraction phase. This phase has persisted for several quarters, exerting downward pressure on real estate values.

Growth and liquidity are fundamental to understanding and predicting real estate valuations, as they are the main drivers influencing the industry's performance.

How do the US and Canada compare and what have they been going through during this cycle?

MacIntyre: The US economy has shown greater resilience compared to Canada in the face of rising interest rates. Despite this resilience, the US has experienced larger capital value declines in real estate in recent quarters. In the US, supply across all asset classes is built faster, causing a quicker shift in the supply-demand balance when market conditions change. This rapid adjustment can contribute to more significant fluctuations in property values.

An interesting difference is the occurrence of keys being given back to lenders on some office assets in the US, a trend not yet observed in Canada. This difference is partly attributed to more stringent underwriting practices by Canadian lenders, including smaller loan-to-value ratios.

The Canadian financial system is perceived as more resilient, with fewer but more well-capitalized banks and fewer instances of high-risk lending.

In Canada, there is more concentrated ownership of real estate. Institutions with strong financial backing are better positioned to hold onto their assets during tough times, reducing the need to sell in a soft market. This approach helps avoid setting lower repricing expectations that favour buyers.

Canada is seen as a safer market for both domestic and international investors due to its less volatile nature. The Canadian market does not experience as rapid growth in strong times nor as steep declines in downturns as the US market. This trend of less volatility has remained consistent pre- and post-COVID.

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