Knowledge exchange

Navigating today's real estate trends

The Credit Crisis & U.S. Economic Slowdown

Is Canada Feeling The Crunch?

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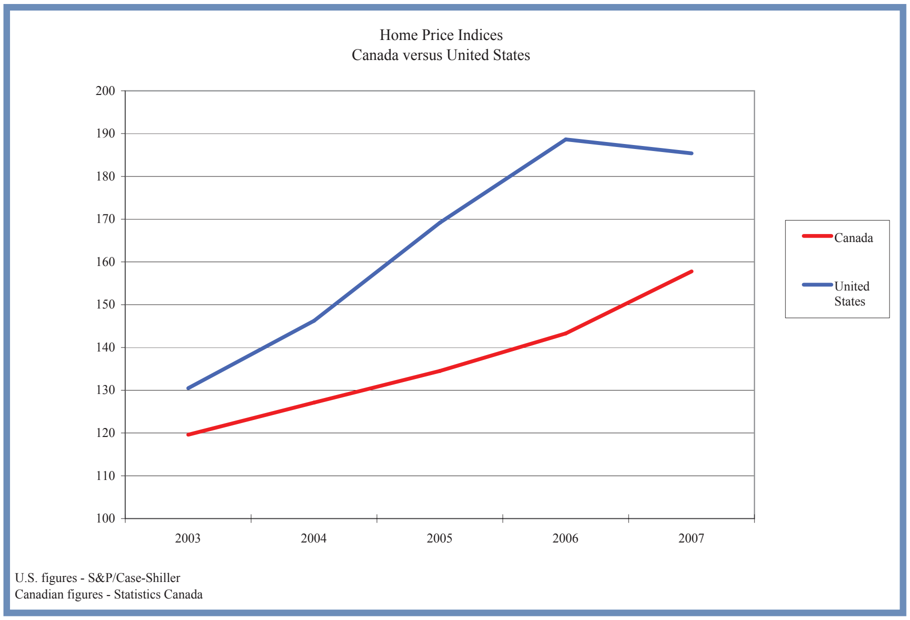
This edition of the Knowledge Exchange compares Canada and the United States, from the viewpoint of cause-and-effect related to the credit crunch, and recent economic turbulence. From this information we explore the potential impact on Canadian commercial property markets.

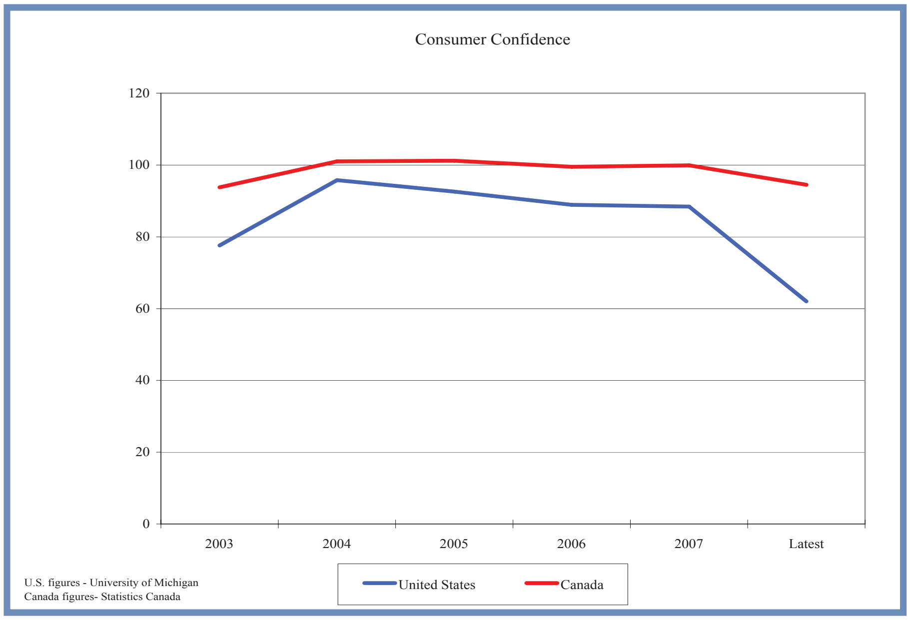
Tracing the credit crunch back to its origins points squarely at the U.S. housing market, and is a result of inexpensive credit and lax lending criteria. The low interest rate environment with easy qualification, and low equity requirements, combined in generating record levels of home ownership across the U.S, increasing from 64% in 1994, to 69% in 2004 notes the U.S. Census Bureau, and has resulted in the rapid escalation of home values.

While many blame the ensuing mess on predatory lending practices, there was also a high degree of predatory borrowing. According to BasePoint Analytics, "approximately 70% of recent early payment defaults had fraudulent misrepresentations on their original loan applications". Many of these misrepresentations were related to the income of the borrower, facilitated by the practice of allowing "stated income", which enabled the borrower to provide an unverified income figure. It is clear that many people were unintentionally over their heads financially, while many others took advantage of their house as an ATM to support unsustainable lifestyles.

By comparison, Canada has seen strong but steady growth in values, more conservative lending and borrowing practices, with less equity withdrawal from homes. The accompanying graph illustrates the extent to which U.S. home value appreciation has outpaced Canada during recent years.

As the U.S housing markets began to run out of steam, the supply of new homes kept rolling, resulting in record levels of surplus unsold inventory. Excess supply, combined with rapidly escalating rates of foreclosure is causing values to plummet in many U.S. markets, erasing the equity in many properties. This reduction, or outright loss of equity has removed the source of easily obtained cash for many consumers, and has slowed consumer spending on discretionary items.





Bruised by the housing market, higher fuel prices and financial market turmoil, U.S. consumer confidence has hit a new low. Hovering comfortably between 80 and 90 during recent years, U.S index levels declined to 62, according to the University Of Michigan, Consumer Confidence Index. This in contrast to the latest Canadian consumers viewpoint captured by Statistics Canada, indicating that consumer confidence was sitting at 94.

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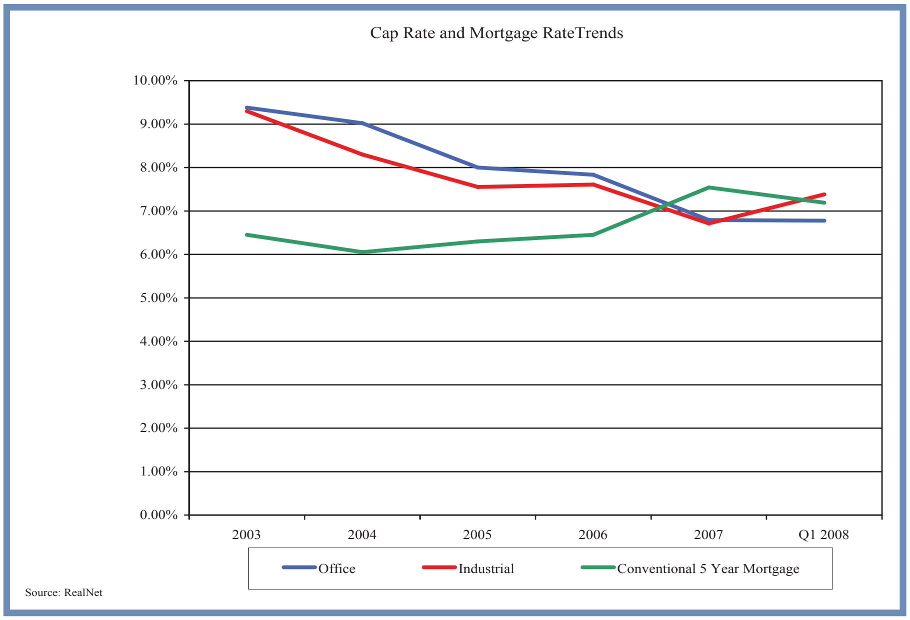
What is the impact on Canadian Commercial Property?

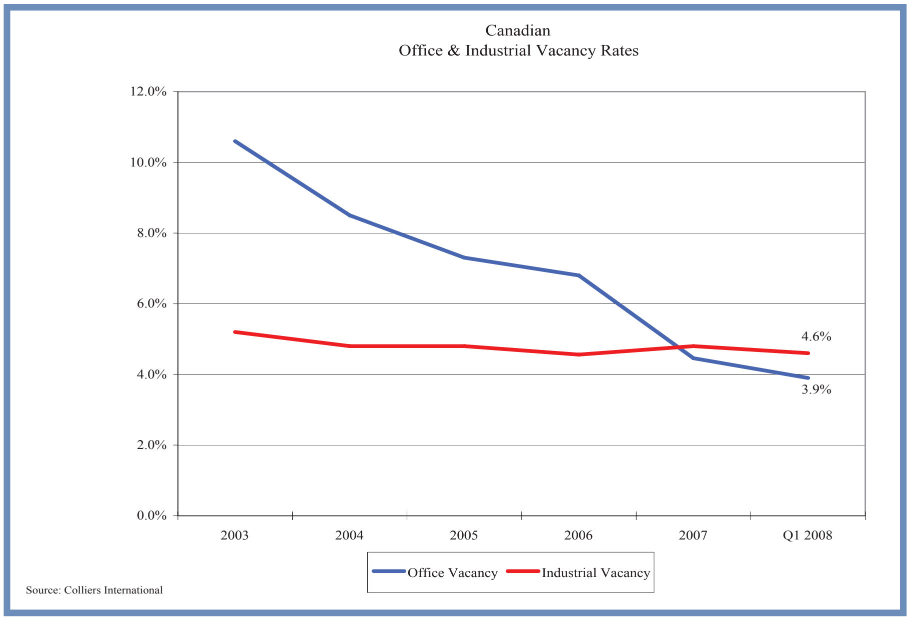
The first visible impact came with the demise of the Mortgage Backed Securities market, which has eliminated a source of competitively priced funds and driven borrowers back to the traditional balance sheet lenders. The cost of borrowing has increased, and the move to more conservative loan-to-value ratios requires more equity from the borrower.

With less appetite for risk, lenders are shying away from secondary markets and ramping up their due diligence efforts. This will reduce the deal flow in these markets, and will likely impact both valuations and new project activity. It could be viewed as a flight to quality, during which quality assets in primary markets will hold their value and be readily financed, while secondary markets and B product will have a diminished ability to obtain financing and a decline in buyer interest.



A widespread result of the increased cost of property investment financing will be upward pressure on cap rates, with the exception of trophy or strategic acquisitions. As investors drive to achieve targeted yields on new acquisitions, vendors are expected to push back, striving to attain the values they have observed pre-credit crunch. This buy-sell disconnect will continue until expectations are re-set, inevitably slowing the volume of transactions.

A less direct, but still notable effect stems from the pullback of the U.S. consumer. Canadian exporters are feeling softer U.S. demand for consumer products, automobiles and new home construction. This comes at a time when exporters are suffering from the high cost of fuel, and a Canadian dollar hovering around parity. This will be most evident in Ontario and Quebec, but will also reach into British Columbia as they feel a drag on the forestry sector. Offsetting this downward pull are two factors: 1) a healthy and active Canadian consumer, backed by solid wage gains, low unemployment and a stable housing market, and; 2) strength in the service sector which has mitigated the impact of the manufacturing sector on economic growth, while producing employment growth and demand in the office sector.



The industrial real estate markets primarily in Eastern Canada will moderate as a result of the softening demand, coupled with the increased cost of financing new projects. Keeping this shift in perspective, a Canadian Industrial vacancy rate of 4.6% remains tilted in favour of landlords. After this brief pause, we anticipate a return to escalating land and rental costs, and continued challenges stemming from a tight supply of development land in prime Canadian markets.

Eastern Canadian office markets will also experience a slow down as a result of the economic forces at play. Activity in the financial sector has softened considerably, and is expected to flow through to the demand for legal and other related professional services.

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Through the healthy backing of natural resources in the West, Western Canadian office markets will remain insulated from these repercussions, and are expected to experience continued demand and a healthy outlook, albeit at a less frenzied pace. Putting the impact into perspective, with a vacancy rate of 3.9%, Canadian office markets are on extremely solid footing, with very little speculative building in the pipeline, and are expected to sustain a landlord's market throughout Canada's major cities.

The bottom line for Canada?

The next twelve to eighteen months will see moderated growth, followed by a swift return to upward pressure on rents and land values, with the availability of space and land returning to the forefront.

This prognosis is based upon economic forecasts that indicate moderate to healthy job growth in Canada's service sector nationwide, and the continued health of domestic demand. Combined with the underlying strength of the commercial real estate markets this points to stability in the near term and a return to growth in the future.

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