

The Goodman Report

FOR APARTMENT OWNERS

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MUSINGS FROM TORONTO: HOW THE BIG ARE GETTING BIGGER — MUCH BIGGER

AN INDUSTRY IN CONSOLIDATION

Five hundred and fifty delegates from all regions of the country recently participated in the *Canadian Apartment Investment Conference* held at the Metro Toronto Convention Centre on September 27, 2006. We were treated to a far-ranging and diverse series of informative panel discussions and speeches from some of Canada's leading property managers, economists, developers, REIT and pension fund managers, syndicators, building technology specialists, senior care home operators and company representatives outlining the merits of converting rental buildings to condos and co-ops.

The delegates, who were offered a wide choice of sessions depending on their particular topic preference, were also exposed to several keynote speakers throughout the day. For a complete list of participants, view www.realestateforums.com and link to "Canadian Apartment Investment" for details on the conference.

The convention's opening remarks were provided by Avery Shenfield, Senior Economist and Managing Director, Economics and Strategy, CIBC World Markets. His speech was titled *A Benign Slowdown*. Shenfield does not see an "ugly recession" coming, rather, he forecasts that the North American economy is gradually slowing down and that long term mortgage rates going into 2007 may drop 3/4 to 1%.

The US economy, in particular, will weaken while growth in India, China and Japan will remain strong. He forecasts a stronger rental market for the US and argued that US home owners are no longer tapping into their home equity which has in the past served as an important engine of growth by consumers. In Ontario, Shenfield believes an economic slow down will occur most noticeably in the manufacturing sector.

The next keynote speaker, Bob Dugan, Chief Economist of CMHC, indicated that demand for rental housing across Canada has been supported by a number of factors. High levels of immigration have been a key driver of rental interest over the past year, as the majority of new immigrants initially settle into rental housing. In most urban centers across Canada, more renters are remaining in their units as the gap between the costs of home ownership and renting has widened. The boost to rental demand from these two factors has put downward pressure on vacancy rates over the past year. Dugan went on to say that in 2005, 94,952 migrants moved to Ontario, 59,043 to Alberta, 43,106 to BC and 28,996 to Quebec.

Regarding cap rates, Dugan predicted that BC's Greater Vancouver will remain in the 3.75-5.75% range, Alberta 5-6% (Edmonton and Calgary with conversions to condos exacerbating an already tight rental market), Ontario 5-6% and Quebec 6-8%.



News and views from David and Mark Goodman

Fact

The Goodman Team, BC's leading apartment specialist, is number 1 in buildings sold and \$ volume 2003, 2004, 2005 and 2006.



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Dugan also suggested that heavy condo construction across Canada will play an increasingly competitive roll for the rental industry as large numbers of investor-owned units offer newer facilities and amenities compared to the older 35-50 year old purpose-built rental complexes.

With further reference to BC, Dugan suggested that Vancouver cap rates have bottomed out, rising operating costs will prove to be a continuing challenge, and vacancy rates will remain approximately the same for 2007, while rent increases on turnover will continue to surge upwards. He also stressed the need in BC for stronger property management, increased branding efforts by owners and a general improvement in amenities.

EXPANDING PORTFOLIOS

In this year's conference, the mood of the delegates and speakers alike was extremely upbeat. We were repeatedly reminded by the major institutional owners made up of principals and senior management from such stellar companies as Transglobe Property Management Services, Timber Creek Asset Management Inc., Morguard Residential Inc., Minto Urban Communities, Osgoode Properties, Boardwalk REIT, 20/20 Group, Cap REIT, GWL Realty Advisors, Real Star Management Partnership and Oxford Properties, that they are all aggressively seeking product throughout Canada to add to their already sizeable portfolios which range from 3,500 to 35,000 units. A recurring theme amongst the group was their desire to acquire under-performing assets for "repositioning purposes". In other words, they continue to seek the opportunity to create "added value" or "enhancement opportunities" for their vast rental holdings. No region in Canada appears exempt from the "acquisition net" being cast by the majors.

Some examples provided at the conference were of communities that have fallen out of investment favour due to a localized economic downturn. In fact, some of these major players, acting as contrarians, have taken the plunge by acquiring discounted assets in marginalized areas, retrofitting the properties and holding on for the prospect of better times.

PROPERTY REPOSITIONING

During the conference, industry leaders shared their corporate philosophy for multi-family rental investment with a captivated audience. While cap rates were frequently cited as one of the key components for determining value, we heard equally about IRR (internal rate of return), ROI (return on investment), price per suite and dollars per square foot.

These same groups enumerated the many remedial steps undertaken by their management teams upon the acquisition of new assets as follows:

- Improve building envelope
- Improve curb appeal by renewing and/or replacing landscaping, fencing and signage
- Fresh paint on building exterior including banisters, etc.
- Laundry room renovation
- Redo piping
- Upgrade windows / replace windows with broken seals
- Elevator upgrades
- Upgrade lobby with ceramic tiling, hallway interiors with long-wearing carpeting and energy efficient lighting and replace mailboxes
- Suite upgrade spending from \$3,000 to \$10,000 per unit including cabinets, appliances, flooring, molding, countertops, sinks, tubs, vanities, lighting, etc.
- Replacing roofs, flashings and repair eaves, etc.
- Undertake an energy audit and, if required for energy conservation, provide elaborate upgrades for state-of-the-art heating systems and water-saving devices (i.e., installation of new aerator showerheads and low flow toilets)
- Upgrades in underground parking (i.e., two tube F8 fluorescent lighting and ventilation systems)
- Attracting and hiring highly professional property management groups and caretakers
- Security improvements including FOB system and/or digital color surveillance system with cameras throughout common areas

Without exception, all speakers (institutional owners and property management groups) were highly

motivated to act decisively upon acquisition in order to achieve the following results:

- Expense reduction / revenue increase while ultimately enhancing value of the property
- Extending life expectancy of the asset
- Improvement of tenant profile and reducing turnover
- Tax efficiency

While the case studies used as examples by the various speakers were in most instances for 100-500 unit complexes, their objectives were no different than goals set by any locally based investor doing a retrofit -- that of achieving a vastly improved return on investment and cash flow for their respective assets.

A FORMULA FOR SUCCESS

Attending the various sessions I was particularly impressed with *Key Strategizing that can help you grow your small portfolios* by Don Campbell.

Campbell, author of *Real Estate Investing in Canada*, points out that size is relative – 25 suites to some is small while 2,000 suites to others is equally small. He insists that owners of smaller portfolios can react quickly but must place safer bets. Also, investors in this group should not buy "just to have in the portfolio", instead they must follow a prudent business strategy. Furthermore, the small investor should not have his assets spread over a wide area, he should instead, be regionally positioned paying careful attention to economic fundamentals. Campbell also recommended that investors follow the competition and look at buildings in the 30-50 unit range which are generally too small for REITs. Quoting Warren E. Buffet, he suggested "put all of your eggs in one basket, and guard the hell out of that basket!"

In the same session we learned that Transglobe, who currently own approximately 18,000 suites across Canada, started with 20-30 suites just 7 years ago. I recommend you download their excellent presentation given at the conference *Business Practice Marketing and Retention Strategies*. Link to: www.realestateforums.com/CAIC/ppt/Brenda%20Hajdu_A1_10h00.pdf.

Next we heard from Ken Ages of Paramount Property Management, situated in Ottawa. Ages described their very hands-on management strategy, spending 2/3 of their time at their various projects consisting of 4,700 suites. This provides them with an immense competitive advantage helping to reduce vacancies and minimize turnover. He also stressed the importance of investing in technology and encouraging excellence from onsite staff. In fact, Paramount emails their tenants periodically to keep them apprised of any new developments in their buildings. Ages also shared with the audience his firm's policy of asking departing tenants about their reasons for leaving. In the competitive Ottawa rental market, the results of the survey provide his company with excellent market intelligence.

Discussions also centered on strategies pursued by some of the institutions concerning their location preferences. One group indicated that C and D properties, typically in less desirable areas and in poor condition, were their primary targets for acquisition. We also learned that many of the ownership groups, in order to control expenses, hedge gas prices and utilize the bond markets to assist in their financing needs. In some cases, the introduction of elevators in walk-up buildings was suggested as a great addition.

In order to compete with the larger institutions, it was recommended that smaller investors should be ready to move quickly and decisively. They must be aware of the community's average income, job market trends and whether local political leadership has created a job-growth atmosphere. Finally, the smaller investor should ally himself with a good mortgage broker.

In *What is your Property Worth?* GWL's Stephen Price offered that "multi-family investment is coming into its own as an investment class" offering stability, cash flow and limited volatility. He also stressed that their investor's objectives are income growth and appreciation.

As rising energy costs have made a significant impact on operation costs for multi-unit residential buildings and have

had a significant effect on value, owners and managers are constantly striving for better ways to reduce these expenditures.

One of the timeliest sessions I attended was called *Retrofitting a Property for the Best ROI: What capital expenditures deliver the best return*. I was particularly impressed by John Mallovy's, of Greenwin Property Management Inc., case study of a residential high-rise heating system retrofit of a 30-storey, 483 suite, 37-year-old complex in Toronto.

Mallovy gave the audience a detailed description of a pre-retrofit building's condition with an extensive overview of retrofit systems including heating boilers, before and after conditions, upper DHW systems and lower DHW systems (before and after) and finally the project costs and savings. These include the following:

- Design Build Fixed Price Contract (\$440K)
- Approved NRCan Funding (\$115K)
- Approved Enbridge Funding (\$30K)
- Estimated Annual Utility Savings pre-construction of \$80K per year or 25% of natural gas consumption, resulting in a projected payback of 3.7 years
- Actual Annual Utility Savings post construction of \$126K or 30% of natural gas consumption, resulting in a project payback of 2.3 years

While few owners in the Greater Vancouver area have complexes of such staggering proportions, the lessons learned here are similarly applicable to an 11 suite building in Kitsilano, 40 suites in North Vancouver or 75 suites in the West End. It pays to undertake an energy audit.

CONSOLIDATORS SHARE INSIGHTS

By virtue of the strong attendance, the various keynote speakers and session presenters, it was clear to all attending that the multifamily rental industry in Canada has definitely arrived and is now recognized as a major investment vehicle within the Canadian real estate market. The industry is entering a new era, one of intense and rapid consolidation by major firms, many of which use public money via REITs and pension funds, etc. Seeking to achieve a critical mass and economies of scale, these investors are amassing large

clusters of units in various markets, be it in Halifax Nova Scotia, New Brunswick, Southern Ontario, Ottawa, Toronto, Montreal, Winnipeg, Regina, Edmonton, Calgary or Vancouver.

Taking snippets of corporate philosophy and mission statements from the key speakers who own or manage some of Canada's largest multifamily rental portfolios, here is a sampling of quotes:

- We look at buying in communities over 25,000 people.
- Our growth strategy – we seek critical mass / large clusters.
- We take advantage of other people's exit strategies.
- We stress energy management and have experienced 22% reduction in energy saving in 7 years.
- If we cannot add value, we do not buy.
- We go for long term solutions (i.e., laminated flooring, ceramic tile, perennial vs. annual flowers, etc.).
- We believe in creating value and encourage close communication with our tenants.
- We are long term holders.
- Our requisition priorities:
 - (a) price per suite
 - (b) low average rents
 - (c) 4-5 cap OK if upside on rents
- We focus on yield.
- We insist on delivering on stated mandate.
- We emphasize Green Strategies.
- We are interested in adding 2,500 suites a year to our portfolio.
- We take advantage of good debt and management opportunities.
- We buy passively operated buildings
- If anyone tells you their buildings are 100% occupied, tell them their rents are too low. You always want to have 1 or 2% of suites vacant and keep pushing the rents.

To best sum up the dramatic paradigm shift in the apartment rental industry over the past 7-8 years, I've included part of an interview that Tom Schwartz, President & CEO of Cap REIT, one of Canada's largest rental REIT, graciously gave to the Federation of Rental Housing providers of Ontario in their July/August 2006 issue of FE (Fair Exchange of Rental Industry News). [🏠](#)

FE What is CAP REIT's mandate?

T.S. Our mandate is Canada, our markets are the 14 major cities in Canada. That's where we will continue to focus our expansion efforts. We have not expressed any intention of going beyond Canada at this point, though we could in the future. Our mandate at this point and time is to own, operate and grow apartments in Canada.

FE Where do you see growth opportunities for Canadian REITS?

T.S. We see growth in all of the major cities in Canada. We are quite optimistic about Ontario. Our head office is located in Toronto and that is where the bulk of our holdings are. We are aggressively expanding in Quebec and we are looking at opportunities in Halifax which is our only Maritime holding at this time. We will also continue to look for apartments in Western Canada.

FE It seems that CAP REIT's occupancy rate, which is already very high in this very competitive market, continues to increase. What do you attribute that to?

T.S. Professionalism and hard work. One of our goals is to make the most money for our shareholders with full buildings at the highest rent. Our whole team is attuned to achieving the goal of higher occupancy and maximum rent and we drive very hard to achieve that goal.

FE Basically you are focused on delivering a higher quality product to your tenants...

T.S. We strive to deliver quality service to our tenants. Good quality marketing and good clean buildings that serve the markets well. It's that simple.

FE You make it sound very simple!

T.S. Well, the key in business is to keep it simple. At the end of the day it is a customer service business. If you have great buildings and they are priced appropriately we are

going to be very successful and we will have many happy tenants and shareholders.

FE What do you enjoy most about working in this industry?

T.S. I enjoy the challenges, I enjoy the opportunities for growth. It's a highly fragmented industry and CAP REIT has been one of the major Canadian consolidators and that continues to be an important challenge for me. I enjoy the people. I think that it is an industry that is becoming more and more professional and I like being a part of that change, as it moves from a relatively simple to a more complex industry.

FE The general public does not think about the rental housing market as a business.

T.S. And that's exactly it, that's the opportunity. The perception is that it is just a mediocre business run by people with not very high standards. That has changed. It is now a professional business populated by more professional operators in a more competitive business environment. The best and the most professional will survive.

FE In light of that, at the early stage of any industry entrance into the market is relatively easy but over time as it matures you get the larger more professional players and the higher standards that you talk about. But a very large percentage of the rental holdings are in the secondary market.

T.S. That is the opportunity. You currently have a lot of people where this is not their main business, but for whatever reason they have ended up owning buildings. Then you have organizations like ourselves who act professionally and are bringing this industry up to another level... And are in a position to consolidate and buy more buildings. Quite frankly that's who we are buying our buildings from: people who don't want to deal with the increasing challenges that the market presents today...

FE Interest rate movements play a varied and critical role in REIT markets.

T.S. It's really the gap. Interest rates in relation to the yields. As long as there is a positive gap between yields and interest rates, it is a good business. As that gap narrows it becomes more difficult. So it's more the gap than the particular interest rate.

FE One of the things that I find interesting during this conversation is how frequently you use the word professional to describe your staff, CAP REIT, and the industry in your answer to almost every question.

T.S. It's a very important difference between what I call the old landlord and the new landlord. The old landlord was not professional and they didn't have to be. The new landlord has to be professional, has to take it seriously and has to be constantly looking to improve on what he is doing. It is now a very competitive business so professionalism is everything.

When we do staff training in our buildings that is exactly what we train... if we are going to have cleaners in our company, they are going to be the best cleaners. If we are going to have marketers, they are going to be the best marketing people. If we are going to give our tenants service, we want to give them the best service because if we don't they can move into the building next door.

FE Any final thoughts?

T.S. The industry is changing and certainly the older style landlord says it's time to get out while the new guys like me say its time to grow and stay in. Like any industry when you don't evolve and change you become a dinosaur and then you die. This is an industry that's evolving now. On a positive point, the other important thing is that it is good for tenants. All of a sudden tenants have better choices in this more competitive environment. 🏠

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