

Eye on Real Estate

Consolidation and growth: navigating Canada's multifamily apartment market

In this edition, we sit down with Thomas Schwartz, President and Chief Executive Officer of Canadian Apartment Properties REIT (CAP REIT). He shares his insights on the Canadian multifamily residential market and the factors that have allowed CAP REIT to grow into the largest multifamily REIT in Canada.

We also offer our insights and lessons learned with respect to dispute resolution in family-owned real estate assets. This is a relevant topic for the Canadian commercial real estate market, particularly multifamily assets, in which private investors continue to be a significant player. Ernst & Young has advised clients through real estate disputes and resolutions in Canada for more than 20 years.

I hope you enjoy reading this issue. It is our continuing endeavour to make this publication ever more relevant to your needs – we appreciate any comments, feedback or suggestions you may have.

Ray Drost
Canadian Leader, Transaction Real Estate

Point of view: Opportunities and success factors learned from Canada's largest multifamily REIT

A conversation with Thomas Schwartz, President and CEO of CAP REIT

Thomas Schwartz is president and CEO of CAP REIT (TSE:CAR.UN). CAP REIT is a growth-oriented investment trust owning a freehold interest in multi-unit residential properties, including apartment buildings and townhouses located in major urban centers across Canada.

Q. REITs and institutional investors have seen considerable activity in the multifamily space, but the industry remains highly fragmented. How has this shaped the growth of CAP REIT, and what are your future growth plans?

A. The fragmented nature of the Canadian multifamily landscape has allowed us to grow through acquisition. In 1997, we started the REIT with an initial portfolio of 2,900 units. Over the years, it has expanded to 31,000 units through acquisitive growth. Our investment thesis has allowed for consolidation opportunities in the apartment sector, and we continue to believe that an acquisition target of 1,500 to 2,000 units per year is reasonable.

Q. CAP REIT has proven to be one of the most successful REITs at driving NOI growth. What has been key to driving NOI margins from 52.2% in 2006 to 56.3% in 2010?

A. Two drivers of our growth margin over the past several years have been a focus on energy management and national procurement. Each acquisition we make drives cost savings to the bottom line by adding our national procurement contracts and enacting our energy management strategies.

Some of our portfolio-wide initiatives include the installation of the following:

- ▶ High-efficiency heating boilers
- ▶ Energy-efficient lighting systems
- ▶ Water-saving initiatives
- ▶ Waste-recycling facilities

We strive to attain economies of scale and cost synergies across the portfolio. CAP REIT's proprietary technology streamlines and centralizes purchasing controls and procedures, and generates significant cost savings through national master-sourcing contracts, improved pricing and enhanced operating efficiencies.

Examples of energy-saving initiatives and national procurement policy include the following:

- ▶ Purchasing energy-efficient light bulbs for the entire portfolio. We've found that installing energy-efficient light bulbs has a six-month payback period, and when factored in on a national scale results in significant savings.
- ▶ Tendering our laundry facilities contract on a national basis.

Given our scale, these cost-saving initiatives tend to be fairly significant to our bottom line.

Q. Given the success of your energy-saving initiatives, what else is CAP REIT contemplating to improve the environmental footprint of its portfolio?

A. We're looking at installing solar panels on our rooftops. Not only would it be an environmental initiative, but it would also act as driver of ancillary revenue. We received a tax ruling that allows us to move forward with solar without compromising the specialized investment flow-through (SIFT) rules.

Q. What is the attraction to the multifamily sector from the point of view of investors?

A. Investing in the multifamily sector has many advantages to the institutional and retail investor, including stable cash flows, predictable increases in rent, low-cost financing and liquidity – all of which make this asset class an attractive investment thesis.

Q. Why have we have not seen any US-based companies enter the multifamily space in Canada?

A. There are a couple of issues that tend to dissuade US companies from entering the Canadian market. They're generally afraid of rent control, and the relatively small size of the Canadian market is less attractive.

Q. A small percentage (4.6%) of CAP REIT's portfolio consists of mobile home community (MHC) land leases in Ontario. Compared to apartments, what makes this asset class attractive?

A. We view MHCs as having similar income attributes to multifamily units but with less cost. Costs tend to be lower as they typically do not have bad debts, and there's less turnover of units. In addition, we retain ownership in the underlying land, which is a bonus.

Q. Considerable capital investment is required to adequately improve and maintain Canada's apartment stock. How would you describe your due diligence process to address the capital deficiencies found within most apartment listings?

A. The apartment asset class provides a significant opportunity for experienced operators to acquire buildings at a significant discount to replacement cost. For the most part, private operators cannot afford to run the capital expenditure programs required to keep the assets running efficiently in addition to maintaining value. That being said, you have to ensure that your due diligence is thorough enough to assess where the real opportunities to reposition the asset lie.

Quite frankly, our due diligence process has not changed much over the years, as we've always performed extensive engineering studies before acquisition to ensure accretive purchases. At CAP REIT, we carefully scrutinize the required costs of capital expenditures when calculating our expected return on a potential acquisition in addition to the bid price.

Q. Many Canadian cities have experienced condo booms over the past decade. As more and more condos are built and sold for investors, how will you work to ensure your units remain competitive?

A. We have to keep our buildings competitive in price and amenities. We shop our competitors to determine whether our rental rates, services and amenities need to be recalibrated and then make the necessary changes. The majority of our inventory is located in the Greater Toronto Area, and we benefit from an inflow of immigrants who tend to rent while they establish roots in Canada.

The location of our assets, which tend to be on key transportation links, has proven to be attractive to the aging population who may not drive but want to retain accessibility. Lately we've seen a move to tenants we call "renters by choice" – people who don't want the hassle of home ownership but would like to remain in their current neighbourhood.

From the living room to the boardroom: dispute resolution in family-owned real estate

As a long-term capital asset, commercial real estate can provide a suitable investment for many private investors, including high-net-worth individuals. It can achieve a number of financial goals, such as recurring income, capital appreciation and tax efficiency. Too often, however, we've found that private owners fail to realize the need for appropriate governance mechanisms, particularly when the asset is family controlled.

The most common situation we see involves a family-owned property that has been passed down successively to the next of kin. As generations progress and the family continues to grow, the ownership becomes fractured – much like shares in a public company. Each successive owner has his or her own risk profile and personal preferences, which often leads to differing objectives and management styles.

Typically, one owner assumes an active role in the management of real estate while the other steps back. However, while there is equal ownership, the benefits are shared between the two parties, and the workload is borne by only one. This can lead to resentment – one owner is growing the asset while the other is concerned with “clipping coupons” and maximizing income.

The owners may also disagree on a number of issues, ranging from management fees and capital expenditures to the levels of leverage and financing. And unique to family businesses is the emotional attachment to the asset, which has been a family heirloom for generations. This can aggravate complications, resulting in an impasse. What makes this dispute more difficult to navigate is the fact that most family-owned real estate portfolios do not have any formal shareholders' agreement; there was simply never a need to draft one during the original acquisition.

So how, then, do the parties resolve their differences? We believe there are two primary methods to dispute resolution: court actions (often involving a partition and sale) and non-court settlements. In our view, non-court settlements provide the opportunity to achieve greater gains and amicable results for all parties involved. In most cases, these settlements are less expensive, as well.

Having dealt with numerous non-court settlements over the years, we've learned that there are a number of critical success factors to help come to a successful settlement.

- ▶ **Full disclosure** - Both parties must agree to provide full disclosure, giving equal access to all information.
- ▶ **Use of professionals** - The use of third-party professionals – including lawyers, appraisers, financial advisors and tax consultants – is essential. When the parties have sentimental ties to the asset and/or personal issues between them, third-party professionals are necessary to remove the emotional element. To simplify matters, it's important to appoint a lead advisor to manage the process who can co-ordinate multiple streams of professional input.
- ▶ **Clear identification of goals** - Parties and their advisors must define their desired outcomes from the process. Defining goals at the outset provides self-awareness and allows parties to know where they can find points of conciliation to help negotiations progress.

- ▶ **Selection of a valuation approach** - Both parties must agree to the use of a single valuation method. The use of one method makes each party's assessments comparable, allowing for subsequent mediation of differences. Parties must also agree on any adjustments to the asset valuation, including “above-the-line” adjustments such as portfolio premiums, goodwill and income tax discounts. Further, agreements on “below-the-line” adjustments such as minority discounts, control premiums and illiquidity discounts must be reached.
- ▶ **Managing expectations** - It is critical for each party's advisors to manage their client's expectations. The dispute resolution process requires time to assess issues as well as to implement recommended courses of action. Clients must also understand that they can't always get what they want. If one party gets everything they want, then the dispute resolution process was not successful.
- ▶ **Ongoing maintenance** - In conjunction with the settlement process, parties need to reach an agreement on how assets will be managed in the interim. The negotiation process can be a trying endeavour, so agreeing on the ongoing maintenance allows parties to put aside a potential source of conflict and focus on the larger goal.
- ▶ **Early discussions with financial creditors and other stakeholders** - In all cases, there will be a fundamental change in the ownership structure. It is therefore critical to notify and negotiate with lenders for the unwinding of “joint and several” debt. Consideration should also be given to other stakeholders, including regulators, tenants and city officials.

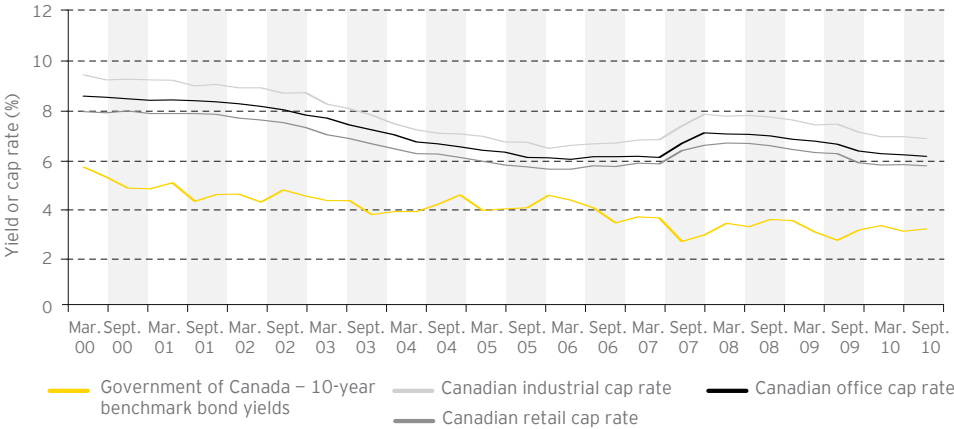
If parties cannot agree to adhere to the above, a negotiated settlement will be difficult to obtain, and the dispute may have to be decided through court actions. But since we believe that non-court settlements generally result in better outcomes, we strive to get all parties adhering to these success factors and work with our clients to focus on their end goals.

For more than 20 years, Ernst & Young has been a financial and lead advisor in real estate dispute resolution across Canada. With a robust and customizable methodology for non-court settlements, we have represented owners of family-owned real estate across all asset classes. Our advisors work with you to understand your goals, develop an action plan and manage the process with your objectives in mind. Working with a team of internal and external professionals, we manage the dispute procedures to work toward a fair and open negotiation process that achieves your goals and seeks to maximize benefits for all parties involved.

To learn more about our integrated Estate and Trust Advisory Services practice, visit us at ey.com/ca.

And to learn how our nationwide Entrepreneurial Services team can help family businesses achieve their goals at every step in their lifecycle, visit us at ey.com/ca/Entrepreneurs.

Canadian cap rates and bond yields



Sources: Bank of Canada, Altus InSite



Ernst & Young Orenda's capabilities

Ernst & Young Orenda Corporate Finance Inc. is one of Canada's largest corporate finance firms focused on mid-market transactions. With more than 70 professionals in 11 cities across Canada, we offer significant industry and regional depth. As part of Ernst & Young's Transaction Advisory Services practice, Ernst & Young Orenda delivers a fully integrated approach to transaction services, including:

Mergers and acquisitions advisory

- Divestitures
- Mergers and acquisitions
- Management and leveraged buyouts
- Recapitalizations

Structured finance

- Structure and arrangement of debt and equity
- Project finance and infrastructure advisory services

Financial advisory services

Transaction real estate

Our transaction real estate team

Here are some of the services we provide:

- Strategic M&A advisory services for acquiring and divesting real estate portfolios and individual assets
- Due diligence, fairness opinions, litigation support, risk analysis, dispute resolution
- Options analysis, feasibility studies, sensitivity analysis, best-use analysis, cash-flow analysis
- Capital markets and project financing advisory for bank debt, mezzanine financing and securitization transactions
- Valuation for purchase price allocation, asset impairment analyses, IFRS compliance
- Valuation of real estate portfolios, individual properties and development projects

Contact us

Canadian Transaction Real Estate Leader

Ray Drost
416 943 4455
ray.e.drost@ca.ey.com

Toronto

Tony Morgan
Vice President
416 943 3834
tony.s.morgan@ca.ey.com

Jeffrey Larcina
Senior Associate
416 943 3984
jeffrey.larcina@ca.ey.com

Adam Zaret
Associate
416 943 3468
adam.j.zaret@ca.ey.com

Vancouver

Mandy Hansen
Senior Associate
604 891 8280
mandy.hansen@ca.ey.com

Alison Seto
Senior Associate
604 891 8469
alison.seto@ca.ey.com

Montreal

William Jegher
Vice President
514 879 8143
william.jegher@ca.ey.com

Ernst & Young LLP

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit ey.com/ca

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

Ernst & Young Corporate Finance (Canada) Inc. is a US registered broker-dealer. Any inquiries regarding transactional services by US persons should be directed to Ray Drost of Ernst & Young Corporate Finance (Canada) Inc.

ey.com/ca/corppfinance

© 2011 Ernst & Young Orenda Corporate Finance Inc.

© 2011 Ernst & Young Corporate Finance (Canada) Inc.

© 2011 Ernst & Young Real Estate Services Inc.

1110-1298438

This publication contains information in summary form, current as of the date of publication, and is intended for general guidance only. It should not be regarded as comprehensive or a substitute for professional advice. Before taking any particular course of action, contact Ernst & Young or another professional advisor to discuss these matters in the context of your particular circumstances. We accept no responsibility for any loss or damage occasioned by your reliance on information contained in this publication.