Looking Beyond Cap Rates:
Generating Attractive Returns in Canadian Multi-Family Real Estate

In Canada, multi-family has historically been one of the top performing real estate asset classes and the only asset class to consistently achieve positive returns across the economic cycle.

While strong historical performance is reflective of strong underlying fundamentals and rising institutional demand for real estate as an asset class, cap rates are trending downward to historical lows. Valuation concerns thus are now top of mind, with many investors asking the question: *"How do you generate sufficient returns when cap rates are at levels that imply valuations are at their peak?"*

Cap Rates Are Not the Only Measure of Returns

Cap rates, which measure the relationship between net operating income (NOI) and market values of underlying properties, are a standard real estate valuation metric and a primary tool used by investors, but are arguably not the only measure of returns.

$$\text{Cap Rate} = \frac{\text{NOI}}{\text{Underlying Real Estate Value}}$$

Overall returns are influenced by all three components of the real estate value creation equation:

- Current Yield (Cap Rate)
- Potential NOI Growth
- Future Value of Underlying Real Estate

Having said that, the valuation question has significant merit. Valuation risks are present and return outcomes more uncertain, however, like any risk, it can be mitigated.

In a lower yielding cap rate environment, returns become mostly driven by NOI growth and the value of underlying assets. It is arguable that **the Canadian multi-family sector is particularly well positioned to generate attractive returns** through solid NOI and rent growth, lockstep with inflation, and appreciation of underlying real estate values, driven by the:

1. Presence of solid market fundamentals and constructive capital flows
2. Ability to acquire assets at discounted valuations
3. Capability to maximize value creation through repositioning efforts (value-add)

Rental Market Fundamentals Remain Strong

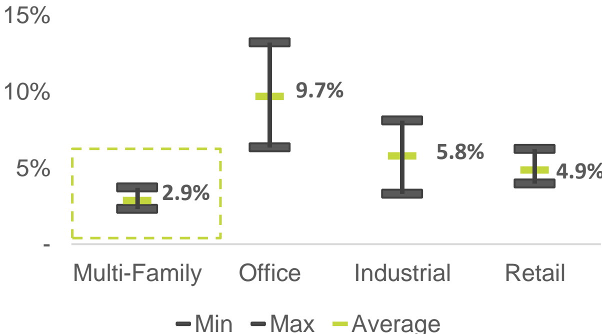
Multi-family property values in Canada continue to appreciate. Investment managers have a healthy appetite for multi-family assets due to its positive demand versus supply fundamentals, defensive nature and above-average cash flow growth profile.

Robust Fundamentals as Growing Demand Continues to Exceed New Supply

- ***Rising Demand for Purpose-Built Rental:*** Rental demand is driven by economic and population growth, job creation for prime renter cohorts and a decline in homeownership affordability.

- ***Scarcity of Product:*** The Canadian multi-family industry has experienced no significant additions to its rental supply over the past 40 years, predominantly driven by physical land constraints, escalating land and construction costs, and conflicting housing policies. This environment is not expected to change in the near future.

Historical Vacancy in Canada (2005 - 2018)



Source: CBRE

According to Stats Canada and the Canada Mortgage and Housing Corporation ("CMHC"), over the past 25 years more than 180,000 households have been formed each year in Canada, as compared to an annual supply increase of approximately 10,000 rental units per year. **This disparity between supply and demand has resulted in stable and declining vacancy and a consistently positive rent growth profile**.

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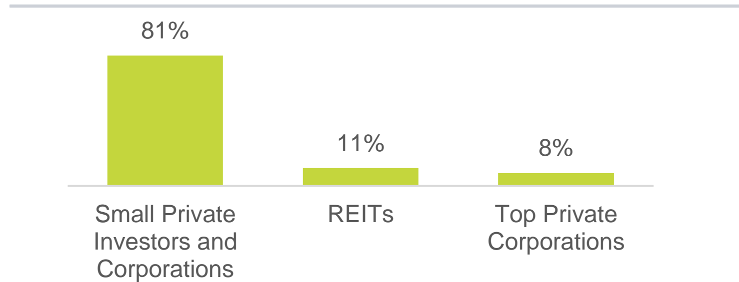
Large Stock of Older, Undermanaged Apartments in Canada

In Canada, the purpose-built rental market is predominantly comprised of older vintage stock, with approx. 80% of inventory built over 35 years ago. At the same time, approximately 80% of the Canadian multi-family market is in private, non-institutional ownership, with landlords often lacking the operational experience, platform and capital to renovate and maximize asset values. Additionally, over 10% of the rental market is comprised of publicly traded real estate investment trusts (REITs), which are typically capital constrained given that a majority of the generated income is mandated to be paid back to unitholders.

As such, much of Canada's current rental inventory is in need of significant capital expenditure. This does not imply that vintage apartment buildings are inferior to newer builds or condominiums. Older rental stock benefits from:

- **Superior Locations:** Proximity to school districts, retail centers and transit nodes
- **Unit Size:** Larger unit sizes ranging from 900 to 950 square feet compared to 700 square feet of newly constructed condominiums (for two-bedroom units)
- **Construction:** Better noise insulation due to concrete construction
- **Parking Stalls:** More parking stalls per unit
- **Lower Relative Rents:** Significant gap versus new condominium market rents

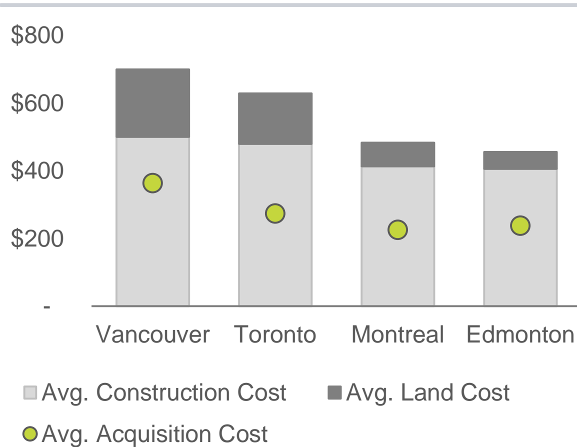
% Ownership of Purpose-Built Rentals



Source: CMHC and Public Filings

Older Stock is Trading at Significant Discounts to Replacement Construction Costs

Multi-Family Construction vs Acquisition Costs (P/SF)



Source: Altus, Colliers, MPAC, JLL, and RealNet.

In general, sophisticated multi-family investors such as Starlight focus their valuations on a relative price basis (e.g. per unit or square foot) rather than soley through the lens of cap rates. From this perspective, Canadian multi-family purpose-built apartments are transacting at discounted valuations, well below construction costs of new purpose built rentals and newer condominium developments, primarily a function of rapidly rising land and construction costs.

As shown in the chart on the left, older vintage purpose-built apartments have recently transacted in the range of $250 to $350 per square foot. This range is significantly below the replacement cost of similar type of residential properties, for which land, construction and development charges are in the range of $450 to $700 per square foot. The relatively high replacement (construction and land) costs of building new residential product, has led to more developers opting to build condominiums instead of purpose-built apartments, which can in comparison generate sale prices well in excess of $1,000 per square foot.

Ability to Access Product is Key

As there is significant demand and virtually no new supply, an imperative component in executing a multi-family strategy in Canada hinges on an investor's ability to obtain access to older product.

The ability to source exclusive acquisition opportunities is one of Starlight's key competitive advantages due to its reputation of being able to quickly and successfully execute transactions, built on a long history of operating and transacting in the Canadian market. This is particularly significant given that approximately half of the multi-family transactions completed in Canada are conducted off-market, allowing Starlight to account for almost 25% of the entire market activity year over year.

Starlight's Value-Add Potential in Canadian Multi-Family

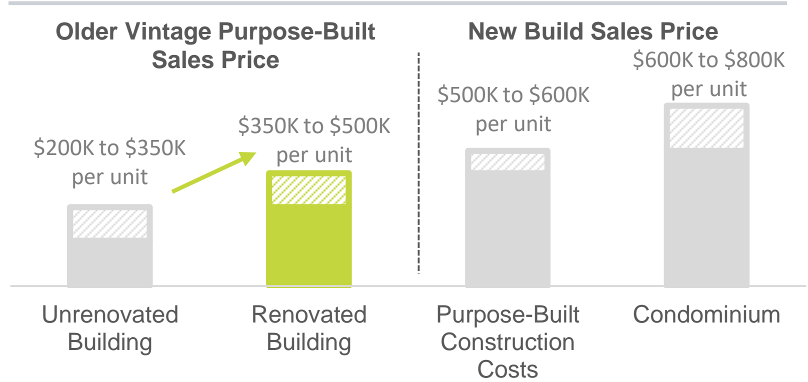
There is a significant value-add opportunity for Canadian landlords that have operational expertise, an established platform and capital to transform older, capitally deprived, rental stock into institutional quality real estate. The by-product of improved quality of living and tenant satisfaction results in rental growth and property value appreciation.

Transformation with Institutional Quality Renovations (More Than a Fresh Coat of Paint)

High pricing of newer apartments and condominiums are largely justified by their modern design and finishes, and sophisticated amenities. Starlight's value-add strategy aims to unlock value and bridge this gap through the material transformation of an older apartment building to an institutional quality level.

As presented on the chart on the right, older apartment buildings in Toronto have on average transacted between $200K to 350K per unit over the past 24 months. Once an existing building is renovated to institutional quality, its value typically appreciates to $350K to $500K per unit. This is a significant increase in value, however remains well below that of construction costs (including land and development costs) for purpose-built rental and new condominium prices, estimated at $500K to $600K per unit and $600K to $800K per unit respectively and rising.

Toronto Value-Add Sales Comparison



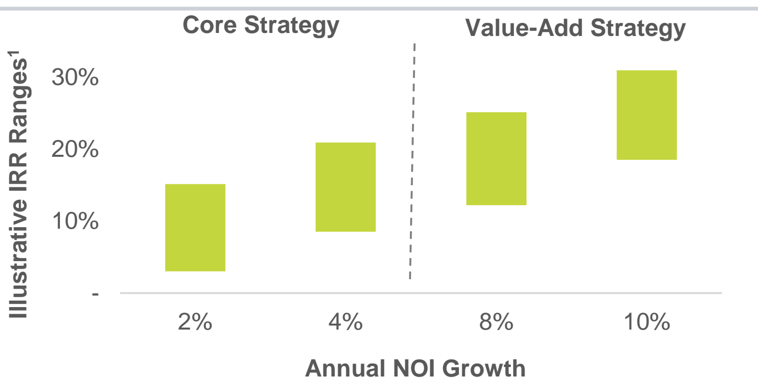
Source: Altus, MPAC, TREB, and CIBC World Markets

The Result: Above Average NOI Growth and Overall Returns

In addition to an appreciation of underlying property valuations, value-add initiatives dramatically improve NOI, particularly for older vintage apartments. Accordingly, NOI growth reflects:

- ***Overall Strong Market Rent Growth:*** Multi-family rental apartments in Canada benefit from a supply shortfall dynamic, driven by continued growth in rental demand and lack of new inventory. Publicly listed Canadian REIT's with an income or yield driven strategy have averaged 3% - 4% NOI growth per year historically without implementing a value-add strategy.
- ***Value-Add Initiatives:*** For landlords with operating platforms and availability of capital, there is an opportunity to reduce operating expenses (e.g. lower property management fees, leasing staff, energy retro-fitting etc.) and generate rental growth by raising in-place rents and ancillary fees (e.g. laundry, parking, storage lockers, etc.). Publicly listed Canadian REITs with a strategy to reposition properties, actively manage rents and reduce operating expenses have averaged 8% - 10% annual NOI growth. Notably, only two REITs in Canada actively implement this strategy: InterRent (IIP-TSX) and Minto (MI-TSX).

Impact of NOI Growth on Returns (IRR)



NOI growth has a material impact on investment returns. As shown on the chart on the left, based on returns seen in a typical Canadian multi-family transaction, above average annual NOI growth of 8% to 10% can generate over two times the returns of a property experiencing market (core) NOI growth.

[1]*Return ranges reflects expected IRR range holding average NOI growth constant over a 5 year term time horizon.*
Source: Starlight Analysis

Case Study: Starlight's Property Repositioning

Unlike many smaller investors and operators in Canada, **Starlight has the scale, operational expertise and capital to acquire and actively reposition its properties, dramatically improving quality of living.**

35 Walmer Road, a 174 unit apartment building located in a prime Toronto neighborhood highlights Starlight's ability to generate returns in a low yielding cap rate environment. The asset was acquired off-market with in-place rents below market rents at the time. The property is located in downtown Toronto by major public transit nodes, numerous schools, the largest university in Canada and retail amenities including one of Canada's most exclusive shopping districts (Yorkville).

Through the execution of Starlight's value-add program, the common areas underwent extensive renovations including a full transformation of the lobby, corridors, and amenity areas, along with elevator modernization and energy initiatives.

Starlight renovated approximately 50% of the units with condominium quality amenities and finishes. The remaining unrenovated units reflect the value proposition of upside for the next buyer.

After a four year hold period, average in-place rents increased by $411 per month (+31%). Strong rental growth and a reduction in operating expenses from energy initiatives contributed towards NOI growth in excess of 10% annually, resulting in a **current internal rate of return (IRR) well over 20%.**

About Starlight Investments

Starlight Investments is a privately held Toronto-based, full service, multi-family and commercial real estate investment and asset management company driven by an experienced team comprised of over 150 professionals. The company currently manages over $9.0 billion of direct real estate as well as real estate investment securities. Investment vehicles include institutional joint ventures, True North Commercial REIT, Starlight U.S. Multi-Family Funds and Starlight Capital Funds. Starlight Investment's portfolio consists of approximately 36,000 multi-family units across Canada and the U.S. and over 5.9 million square feet of commercial properties. Please visit us at www.starlightinvest.com and connect with us on LinkedIn at www.linkedin.com/company/starlight-investments-ltd-.

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