Real property. Real leadership.

REALPAC / FPL Canadian Real Estate Sentiment Survey

Q4
2018

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Exhibits

REALPAC (Real Property Association of Canada) and FPL Advisory Group are pleased to announce the results from the fourth quarter 2018 REALPAC / FPL Canadian Real Estate Sentiment Survey. The survey is the industry's most comprehensive measure of senior executives' confidence in the Canadian commercial real estate industry. This quarter, the survey captured the thoughts of a wide variety of industry leaders, including CEOs, presidents, board members, and other executives from a broad set of industry sectors, including owners & asset managers, financial services providers, and operators & related service providers. The quarterly survey measures executives' current and future outlook on three topics: (1) overall real estate conditions, (2) access to capital markets, and (3) real estate asset pricing. Survey respondents represent the retail, office, industrial, hotel, multi-family, residential, and seniors residential asset classes.

Topline Findings

- The Q4 2018 index came in at 49, up from 48 in Q3. We have observed less foreign capital being deployed into Canada, which may be a consequence of stricter government regulations. However, the rise in interest rates will have an impact on capitalization rates.
- Urbanization persists within multi-residential and office product. This is indicative of rich development pipelines and very low vacancy rates in downtown cores such as Toronto and Vancouver.
- High quality assets continue to increase in value, attracting investment, while secondary assets struggle for bids. Industrial and multi-residential have outperformed, while retail generally continues to underperform.
- Overall, debt capital remains available and lenders continue to be competitive. Less established groups without a track record, may experience more difficulty in acquiring credit.
- Although equity investment remains available, it has not been as active. Similar to accessing debt, those with a strong track record have fewer issues sourcing equity than lesser-known groups.

Data Collection

Data was collected during October 2018. In the pages that follow, survey responses are supplemented by excerpts from interviews conducted with senior executives from Canadian property developers and owners, institutional investors, asset managers, and other organizations.

The most comprehensive measurement of senior executives' confidence in the Canadian commercial real estate industry

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General Market Conditions

The Q4 2018 index came in at 49, up from 48 in Q3. We have observed less foreign capital being deployed into Canada, which may be a consequence of stricter government regulations; however, the rise in interest rates will have an impact on capitalization rates.

"Similar theme to last year, everything is finely priced with diminished margins for error. Better quality assets continue to move up in value. Secondary properties struggle to match the frenzy that we had before. There's a differentiation in the market with more opportunities in other markets like Western Europe and the US."

"Governments seem to be doing everything possible to put roadblocks in front of the delivery of housing, and that's causing a supply problem and will ultimately lead to higher prices. In addition, cost issues like construction are really challenging, and layered onto that are interest rate increases, so we are at a pivotal time and I am not sure how it's going to land. On the investment side, higher interest rates are definitely going to have an impact on cap rates; they have to."

"There's a bifurcation between the have's and the have not's; those with track records who are well-liked are finding capital and those without are not."

"While interest rates are slightly going up, prices haven't really reflected that movement. Conversely, cap rates are broadly going up in the US; it excuses certain things with unbelievable dynamics like e-commerce or fulfillment industrial. Generally 4 caps are becoming 4¼ or 4½ as our rates are going up; now [the US] base rate is higher than ours but that's not new. So that's either a paradigm shift or a lag, or who knows what, but it's curious."

"Groups seem a little bit more spooked about NAFTA and south of the border. The depth of a bid on larger assets is probably shallower than it was in prior quarters. That's not to say that a good asset is not going to attract a bid, whether its domestic or foreign, but the number of bidders at the table just seems lower."

"There's a massive upswing in industrial; retail's pain is industrial's gain. It's not truly linear but there is a correlation between those two asset classes. We're starting to see some very high anomalies or maybe it's a trend of where rates are going, some, but not all of which is e-commerce fulfillment. There's a shift from rent costs being the driver to transportation costs being the driver. If you believe that, then it isn't okay, for example, to be in Caledon or Milton (Ontario) if you are trying to service Lawrence Park. You want to be closer to it. But there are lots of ways you can get at that; not the least of which might be defunct retail, which is close to the people. You can put things in there and distribute them much more quickly. So that's a trend going on."

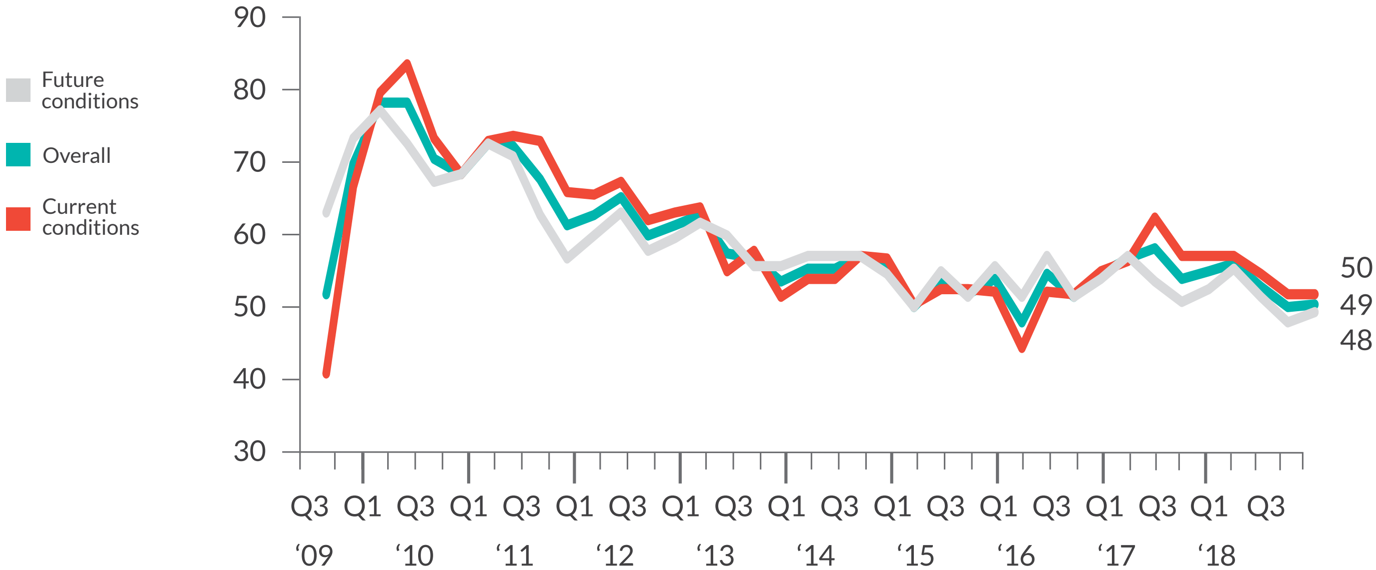
"It feels like we've witnessed less visible foreign capital into our market, so you don't have the big, flashy Anbang or Zara or Kunyuan in Vancouver buying $400 million assets. It seems to be more domestic."

"There is a buy/sell gap; valuators are still holding true to values from a year ago."

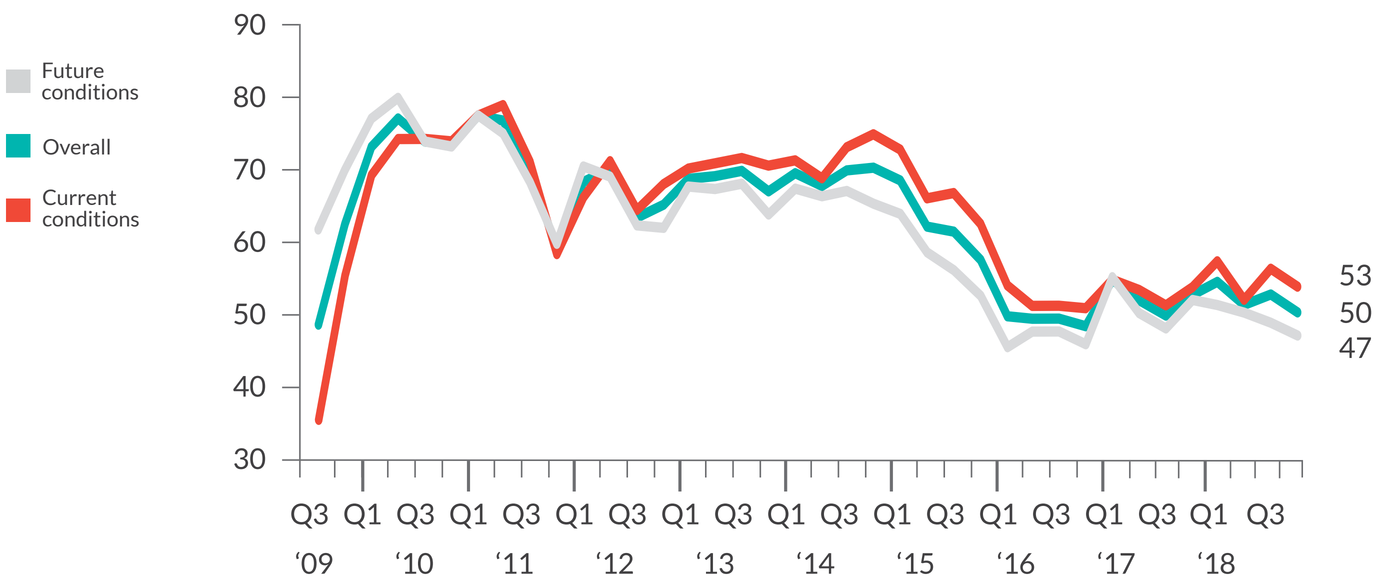
"Generally speaking, government is widely involved in our industry and is probably a much bigger threat to having a successful marketplace where everything is in balance, and that goes right across the country. It's in places like Nova Scotia, Québec, Ontario, Manitoba, and BC. Saskatchewan and Alberta don't have it, but they are still pretty grim; the balance there is that they overbuilt for some time so they will have some time to recover from that."

Exhibit 1:

REALPAC/FPL Canadian Real Estate Sentiment Index*



Real Estate Roundtable Sentiment Index (U.S.)*



*The REALPAC/FPL Canadian Real Estate Sentiment Index and The Real Estate Roundtable Sentiment Index, organized by FPL Advisory Group, are created using the same survey methodology, questions, and timing.

Key Real Estate Considerations

Urbanization persists within multi-residential and office product. This is indicative of rich development pipelines and very low vacancy rates in downtown cores such as Toronto and Vancouver.

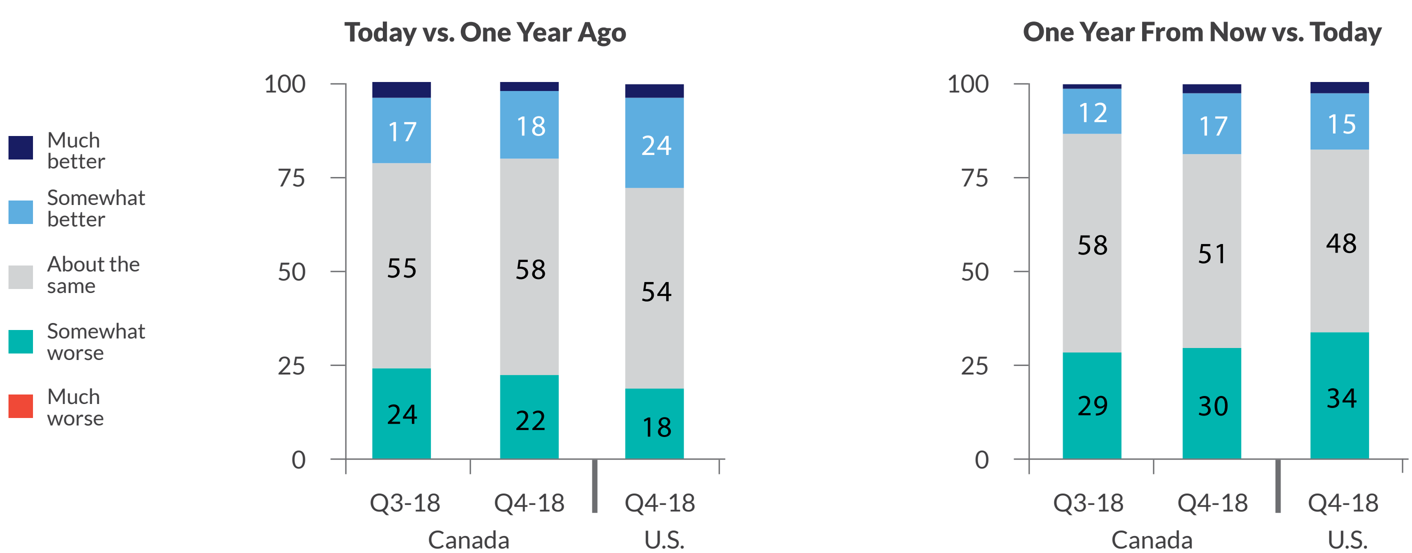
"I haven't seen it yet, but what I am reading on the market (on the condo side) is that people are very concerned with regulations and the process in getting product approved and getting land rezoned in the city of Toronto, and that's a problem. This covers additional regulations in Vancouver and even threatened regulation in Montreal."

"I'm glad that I am not 25 years old and trying to rent something."

"We are seeing continued urbanization and a shift into downtowns. You can see it in the insanely low vacancy rates, particularly in Toronto but also in Vancouver, and a tightening in a few of the other markets excluding Alberta. That trend is continuing to come along, and if you look at the development pipeline in Toronto with similar size inventory basis, you will see a high volume in downtown versus the suburbs. The action is all focused on downtown for the new supply as well, not only for the $6M that is under construction but also for the next $5-10M that is in planning. So that's interesting to watch and a continuing trend. We're not seeing it across all property types but across office, and the sizeable outperformance of rental residential and rental growth is in and around the downtown and transit corridors."

"There's still a lot of activity coast to coast. There are markets that remain very strong and others that have suddenly been put on a "watch list", like BC with the new NDP government. They've made a lot of changes, for example, cutting the rent increases by about 40%. Before you used to get inflation plus 2% (and that 2% was intended to look after everything else like replacing the roofs, fixing up the exterior of the building, all the major capital), that way you didn't have to apply for it like you do in Ontario, and so some years it's enough and others it's not, but it kind of works out. So they've changed that and they've applied it to new buildings as well, so it's been a real problem. Plus land transfer tax in BC (if you can believe it) is 5%! So a single 1,200-suite apartment building can have a land transfer tax of $6.5 million! I would say that [with regards to] the market generally, people are hitting pause; and that's politically and economically driven, because interest rates continue to move up, and the numbers that we are talking these days are such that a move of interest rates of 1% could be a 35-50% increase to what we were paying a year ago. Those would be the two reasons for a sense that the market is cooling somewhat. We do still have some international investors who like the fundamentals here and they are coming in and keeping the market hot. But certainly a lot of people are dropping out of the bidding. Generally speaking, we feel that we are close to a pause right across the country."

Exhibit 2: **Perspectives on Real Estate Market Conditions** (% of respondents)



Asset Values

High quality assets continue to increase in value, attracting investment, while secondary assets struggle for bids. Industrial and multi-residential have outperformed, while retail generally continues to underperform.

"Asset values have held, but we may be on the eve of change if interests rates move up, so there is a bit of concern in the market. On the other hand, there is still demand for Canadian investment product, our economy has been doing well and demographic growth is there. The good thing is that the business is very institutionalized. There's a lot of equity, there's not a lot of spec building, and (even if there is a pull back or a recession or a change), I think we are well positioned to go through a change in the marketplace."

"Surprisingly stable for those going after high quality assets, particularly as it applies to land. Vancouver market values are extraordinarily high."

"The two hottest asset classes this year continue to be multi-residential and industrial. Industrial became the 'flavour of the month' this year. Retail continues to trade at a discount in secondary markets."

"My sense is that they have peaked and it will take another probably 0.5% so the demand is falling off. That usually means prices have flattened and then it really depends on whether the newer buyers can maintain it as more or less flat. A pause in the market is my sense."

"We're generally finding asset values to be relatively stable. You might see some cap rate compression in the multi-family space. Industrial continues to be highly sought after so we see some compression there. When I talk of the depth of a bid, we are still finding it's pretty deep around industrial. There's a bifurcation on the retail front, whether it is by quality or location. There's been a lot of retail product that has come to market. There's upwards pressure on cap rates for some of that secondary and tertiary retail. It just feels a little quieter."

"Value increases have been in industrial and multi-family, and a combination of cap rate compression for some and rent growth. Office is pretty good and retail is really choppy, with some really not so good and some okay. Generally the three asset classes are pretty much firing (two out of the three are really firing) and one (retail) is having its challenges. The values are following that. So for those two asset classes, values are moving nicely. Office less so; I'll never say 'it's had its run', but it had a good run so there's a bit of catch-up to be done there, you have to perform. You do see significant prices per foot moving up markedly (in all asset classes but it's obvious in office). When

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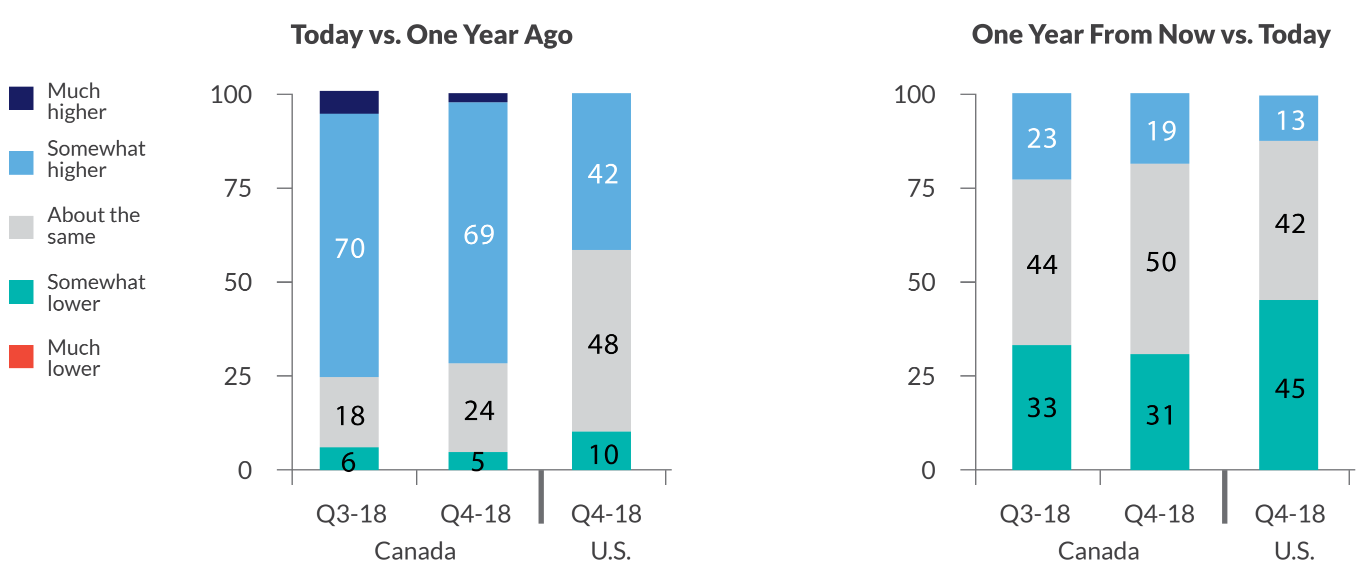
Exhibit 3: **Real Estate Asset Values** *(% of respondents)*



you see Telus at $9.50 a foot and Shaw at $1k a foot … those are staggering numbers, way above replacement costs unless you ascribe to the new land values and say to yourself 'well, to get a piece of land in Vancouver, I have to pay the same as the residential guy at $300-500 per foot so therefore it must be $1k a foot for an office building'. We hope that's not true. That would make building buildings tough. There's not a lack of buildings being built, but they are all being built off former land costs. Same [trend] in Toronto."

Debt Capital

Overall, debt capital remains available and lenders continue to be competitive. Less established groups without a track record, however, may experience more difficulty in acquiring credit.

"Debt capital is just as available as it was."

"Availability of debt is strong if you have a track record and the credit space remains competitive with higher yields."

"Debt 100% continues to be available; whether it's secured mortgage or public bonds (unsecured debt), debt is plentiful — up slightly from last year."

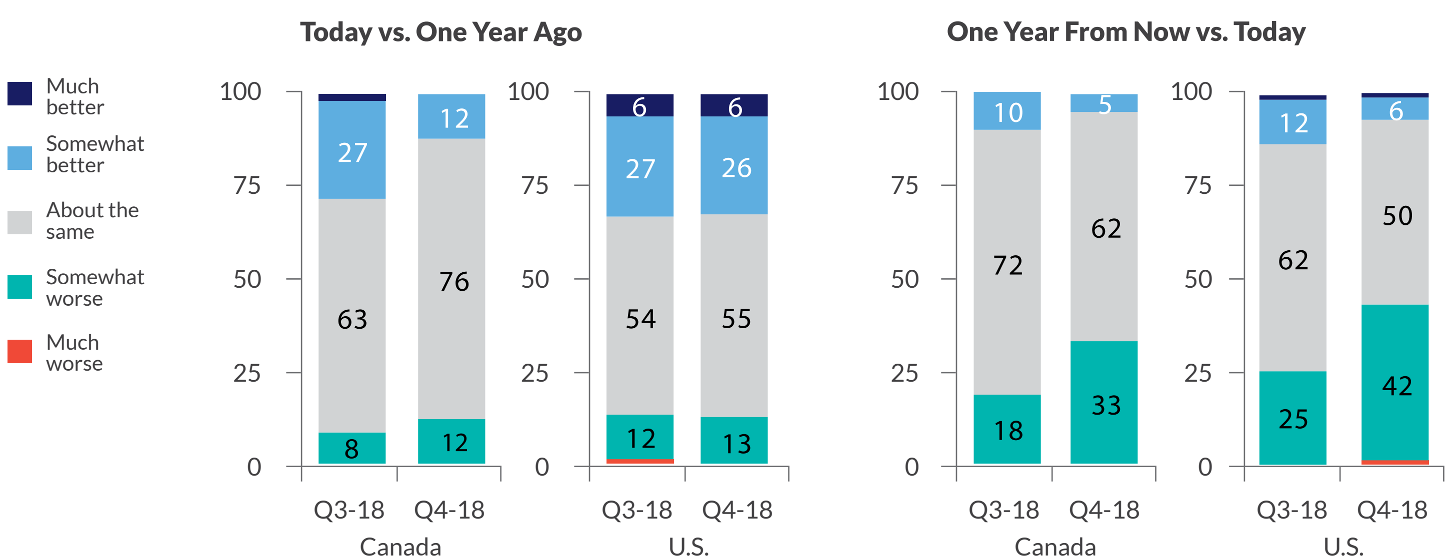
"There's plenty of availability of debt capital."

"No problem with debt for established companies with relationships with the major banks and insurance companies. For others, [lenders] may decide to cut back for the newer entries into the market and less established ones, as it is the established players that really will continue to get what they need because of the relationship side of the business as opposed to just standing on the economics of the deal."

"With regards to debt, again pretty sharp pricing for good assets!"

"Absolutely! There is certainly no lack of debt capital and lots of providers of non-bank loans. All of that stuff is actually quite competitive, keeping pricing quite tight. Spreads are coming down a little bit because base rates are going up, so guys will accept a little lower spread to get the 'all in' rate. The rates are getting close to 4 and the cap rates are hovering around 4, and that makes you go 'hmmm'."

Exhibit 4: **Availability of Debt Capital** (% of respondents)



Equity Capital

Although equity investment remains available, it has not been as active. Similar to accessing debt, those with a strong track record have fewer issues sourcing equity than lesser-known groups.

"Equity capital is just as available as it was."

"Availability of equity is strong, if you have a track record."

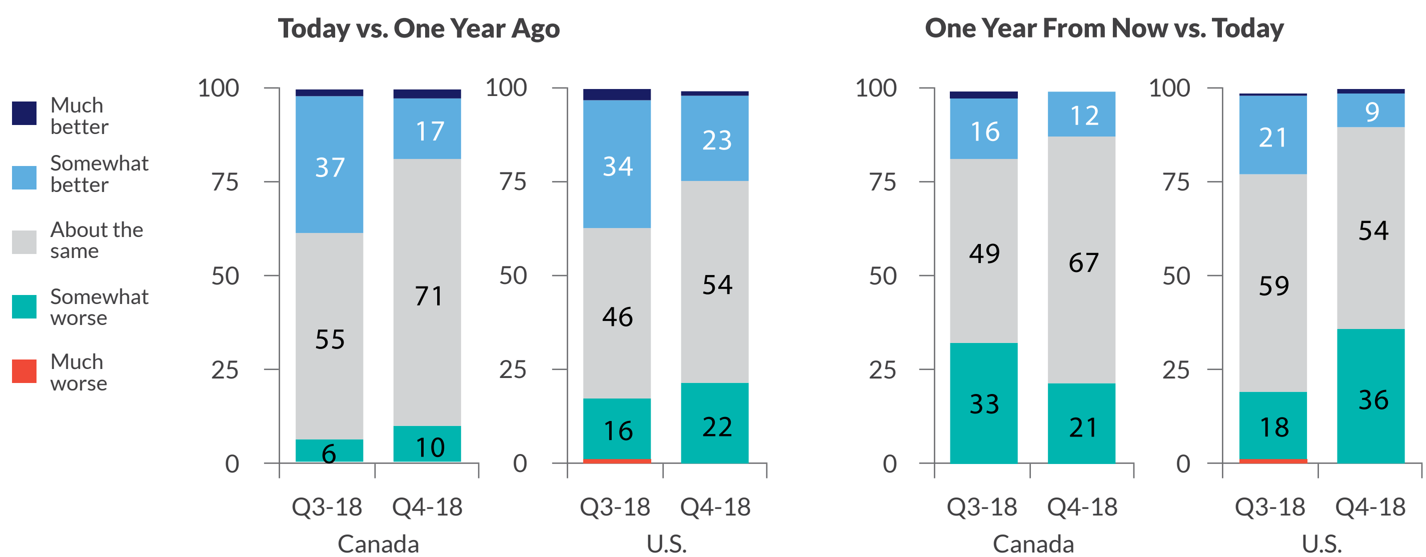
"Equity is readily available but it's a little more cautious. For the more established companies (whether they get the money from the pension funds or insurance companies or even the public markets), there's still a fair amount of support, because people still want apartments and manufactured housing, for example. So the equity is there, it's just a question of whether you can get the returns that people need, and the smaller guys are having a much tougher time."

"There still seems to be a lots of capital in the system, both equity and debt, but groups are a little more gun shy about deploying that capital. And that could be sensitivity due to the macro climate in the US/the trade considerations. The capital is still there, but it probably hasn't been as active as in the last quarter."

"Pretty strong in terms of equity capital; I'd never say bottomless, but pretty strong for "the right thing". It's like the houses in your neighbourhood, the right one comes up and it's a bidding war. The wrong one comes up and no one looks at it, it doesn't even get a sniff. It's the same thing in commercial, for the right property (whether that is appealing to the advisors or to the private guy or foreign investors or someone with an investment thesis that everyone is rallying around) in urban multi-residential (be it rental or condo), you get a great big deep bid. I have seen offerings with 3 bids or 0 bids or 30 bids! And 30 bids is a lot! It would depend on the asset. But I would say that, for what folks want, there is no lack of capital. For certain asset classes and certain assets, it gets more difficult to understand who would buy that/who has the capital for that? There's a lineup of guys for a downtown Toronto residential site, but is there anyone for a downtown Edmonton residential site? Is there anyone for a secondary/regional mall or a community mall, which is even tougher? It depends what's on the menu. So no lack of capital for the right thing."

"Plenty of equity for institutions. Not as much REIT equity available to buy. There seems to be more private money."

Exhibit 5: **Availability of Equity Capital** (% of respondents)



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