Northern exposure

Why commercial real estate in Canada? Why now?

by Carl Gomez

The Montreal skyline: Institutional property net earnings growth never dipped below zero through the recession in Canada.

Canada distinguished itself as one of only a handful of developed countries to experience a strong economic recovery from the depths of the 2008 financial crisis. Much of this resilience is due to Canada's healthy and stable institutions. In particular, Canada's banking sector remained well capitalized through the crisis, and, according to reports by the World Economic Forum, it has consistently ranked the soundest in the world for the past three years.

While most advanced countries are dealing with significant government debt and deficits that will likely constrain their growth prospects for years to come, Canada's fiscal situation remains comparatively healthy; the Canadian federal government is likely to be out of deficit by as early as 2016. Canada is also a country with a rich store of energy and other commodities that is highly desired by rapidly growing emerging countries. Such demand has helped to drive healthy growth in income, corporate profits and government revenues during the past decade.

These positive long-term fundamentals are a major reason why Canada is increasingly viewed as a safe haven by global bond investors and why support for Canada's currency will likely keep it near par with the U.S. dollar for the next several years.

But healthy domestic factors make investments in Canadian commercial real estate just as attractive. As most real estate investors recognize, the opportunity to earn strong future rental growth ultimately rests on property market fundamentals and implicitly on the strength of underlying economic and labor market conditions. To that end, Canada has successfully recouped all the jobs it lost (and more) since the global recession in 2009. This has translated into solid growth in tenant demand in nearly every major property type. Together with limited new supply growth during the past few years, real estate vacancy rates in Canada have fallen to historically low levels. There are sharp differences in property market conditions between Canada and its southern neighbor. The struggling U.S. economy and job market have produced

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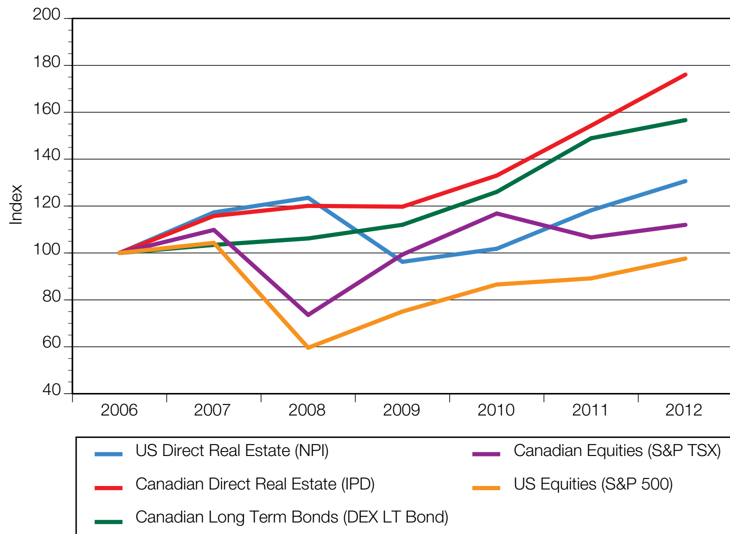
comparatively limited progress in its commercial property markets, which is characterized by much higher vacancy rates and modest demand growth.

Healthy Canadian property market fundamentals have paid dividends to Canadian real estate investors. Unlike the United States and many European real estate markets, institutional property net earnings growth never dipped below zero through the recession in Canada, averaging 2.6 percent during the past five years. This is comfortably above the 1.8 percent average rate of inflation in Canada during this period.

Cumulative total returns performance by asset class



Index: 2006 = 100
Sources: IPD, NCREIF, Bloomberg, Bentall Kennedy

New supply pipeline well contained

The stable demand and low vacancy of investment-grade commercial property in Canada are also providing investors with opportunities to develop new product, particularly in the rapidly urbanizing cities of Calgary, Toronto and Vancouver. Development returns are currently attractive, although the higher yields achievable with this type of real estate investment often require taking on more risk. But given relatively low vacancies, most commercial property developers in Canada have been able to successfully pre-lease projects to mitigate some of the risk.

While development opportunities are available in Canadian real estate, the death-knell for future property rental growth has always been too much supply. A disequilibrium caused by excessive development ultimately limits and reverses the rising market rents that motivated this new supply in the first place.

Fortunately, new supply has been extremely disciplined in most Canadian markets. Prospective new supply is a mere fraction of what was seen in previous real estate cycles in Canada — particularly the 1987–1991 period. This discipline is due both to a banking sector that tempers construction lending on a speculative basis and a development industry that is dominated by well-capitalized pension funds rather than merchant builders. Barring a material change to demand conditions, such discipline ensures that the current property earnings growth cycle in Canada will not be derailed by excess supply going forward.

Outperformance

Robust property fundamentals and the prospects for stable cash flows are a major reason why direct real estate investments in Canada have outperformed real estate markets such as the United States as well as other asset classes.

To be sure, falling interest rates across the developed world have helped to drive not only long-term bond returns but also real estate returns, as it has also helped to compress property yields and increase values. Despite historically lower going-in yields in both bonds and real estate, the spread between direct real estate in Canada and real (inflation-adjusted) fixed-income investments remains at a historically high and attractive level. For example, Canadian direct real estate yields currently offer more than a 400 basis point spread over real 10-year Government of Canada bond yields, and roughly 300 basis points to 400 basis points over real Canadian 10-year corporate A bond yields. These spreads are about 100 basis points to 200 basis points higher than long-term historical averages, suggesting Canadian real estate continues to provide good relative value for yield-hungry investors.

Bottom line

The decision to invest in Canadian commercial real estate is particularly attractive at the moment, given current property and financial market conditions. Of course, Canada is not immune to potential global economic turmoil, principally from the United States — Canada's largest trading partner. Any unforeseen macroeconomic shock would undoubtedly have negative spillover effects on Canadian real estate investments, especially via capital market conditions. But the corollary is also true. Any significant improvement in global and especially U.S. economic conditions is just as likely to result in better potential earnings growth in Canada.

This is a particularly compelling notion considering that if there was no global economic turbulence to begin with, Canada's commercial real estate outperformance during the past few years may have been even greater. ❖

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