2016 PERSPECTIVE

ON REAL ESTATE | CANADA

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On the cover: KPMG & Promenades Cathédrale , Montreal, QC
(Owner: Prime Canadian Property Fund)

Contents

2 St. Thomas, Toronto ON
(Owner: Prime Canadian Property Fund & Kingsett Capital)

A Time of Transition

The Canadian economy certainly faced some significant challenges in 2015. The biggest (and one we drew early attention to in last year's Perspective) was the global rout in commodity prices and especially oil, which ultimately pushed Canada's economy into a brief technical recession. Oil's continued decline due to weak global growth and excess supplies has been especially tough for Alberta. Together with diverging economic outlooks and expected interest rate differentials with the U.S., it has also materially weakened the Canadian dollar. These developments highlight just how much of Canada's overall economic fortunes are being shaped by events outside its border.

> " After an extended period of strong absolute returns and better performance relative to its peers, Canadian real estate markets now face more difficult conditions. "

Although we do not expect commodity prices to rebound to their former glory anytime soon, we remain cautiously optimistic that those regions and parts of Canada's economy and real estate market not associated with the resource sector will remain fundamentally stable. In fact, the combined impact of the continuing U.S. expansion and the weaker loonie should ultimately result in stronger export growth in non-commodities, a sector which still forms a significant part of Canada's economy. This should lead to renewed job growth, especially in manufacturing and warehousing. Further job growth will come from continued growth in service exports, ranging from business and financial services to tourism and call centres. Along these lines, the biggest beneficiaries of what we deemed a "rotation of growth drivers" are likely to be Ontario, Quebec and BC.

One key for avoiding another dip into recession is how well Canadian households hold up. Despite concerns about income prospects, consumers managed to drive a material increase in retail sales in 2015 along with further growth in the housing sector. Much of this was on the back of lower gas prices, but also lower interest rates, which the Bank of Canada has indicated will remain low for some time. But this good news may create further risks down the road as already high consumer debt burdens reached new highs in 2015. Unless incomes increase significantly in the future, the level of consumer debt could constrain further material increases in consumption.

Strong population growth driven by immigration is also a distinguishing factor for Canada (and the U.S.) and we continue to believe that many underestimate the positive, transformative effects it has had on the economy and property markets. Population growth has, of course, been a direct source of demand in Canada's two strongest housing markets – Toronto and Vancouver. To be sure, the rapid rise of house prices compared to incomes in these two key markets is another "home-grown" risk for the Canadian economy. But as explained in Chapter 2, we believe that a "soft landing" rather than a capitulation like the one experienced in the U.S. in 2008 is still the likely outcome. This is largely because interest rates are not likely to materially rise anytime soon.

Continued low interest rates are largely due to a global surplus of capital and forms part of what we have called the "New Normal." We believe that this "free money" will remain a powerful driving force in global investment markets. In fact, a disproportionate share of global surplus capital has flowed to North America in recent years as investors show a preference for the more attractive fundamentals in Canada and the U.S. compared to other parts of the world. While investors must always be vigilant about rising interest rates, we continue to emphasize that the risk of substantial interest rate increases is limited when economic growth, and thus the demand for capital, remains weak in much of the world.

Low interest rates have continued to directly impact Canada's commercial property markets in 2015. Property yields declined to around 5% with prime urban properties trading as low as 4% in Vancouver and Toronto, albeit this was still comfortably above yields in the government bond market. For much of the time before and after the Great Recession in 2009, declining real estate yields were supported by robust income growth in Canada, resulting in very strong capital appreciation. As property values rose above replacement costs, new commercial development also materially increased after being dormant for over a decade.

New development has been especially apparent in major downtown cores, where new office supply is presently at its highest level since the late 1980s boom. With demand growth recently slowing, the first wave of new office deliveries has resulted in significantly higher downtown vacancy in Vancouver and Calgary, albeit from very low levels. As further supply arrives over the next two years and with demand fundamentals remaining generally weak, we expect vacancies to moderately rise in most major markets with more appreciable increases in the oil-ravaged markets of Alberta.

These trends are driving quoted office rents lower. When combined with continued marginal increases in operating costs and lower occupancies, we believe that the period of strong income growth in the office sector has ended for now. Clearly this is a time when investors should expect lower returns from the cyclical office sector but we also believe that expertise in sustainable property operations and tenant engagement brings the greatest relative rewards. Indeed, retaining tenants and minimizing operating costs are critical for driving office returns through this part of the cycle.

As noted above, retail sales growth in Canada improved last year. This had a positive effect on the performance of some retail properties as mall sales productivity grew to an all-time high in 2015. But we believe this positive news for retailers and landlords may be fleeting as a number of headwinds develop in the sector. Consumers will be challenged by increased debt levels, slow job growth and higher prices. Meanwhile, an intensely competitive operating environment could continue to result in "retailer deaths" such as the high profile collapse of Target Canada last year. To survive, successful retailers must focus on improving the shopping experience, embrace rather than ignore the use of technology among customers, ruthlessly limit operating cost increases and concentrate on locating in the strongest shopping centres. Successful retail landlords have and must continue to invest in their properties to keep them vibrant and experiential for shoppers, while also meeting the demands of the most attractive retailers.

As we anticipated in last year's Perspective, the strengthening U.S. economy, the materially lower C$, and the continued integration of cross border supply chains supported improving fundamentals for industrial properties in 2015. Demand remained especially strong for distribution and warehouse properties. With ever greater need for speed and efficiency in meeting orders, suppliers have increasingly turned to third party logistics (3PLs), who in turn require the latest in modern, large bay warehouses with seemingly ever higher clear heights close to major population centres and key transportation networks. We expect continued demand for the "latest and greatest" distribution buildings with this segment likely to continue driving moderate income growth for landlords. Manufacturing, the other major industrial user, did not recover as strongly in 2015 as we expected, but we continue to believe the dramatically lower loonie will eventually spur stronger leasing demand in this segment, especially in Central Canada. In tandem with continued growth on the distribution side, we believe these trends suggest that industrial will remain one of the better performing property sectors this year.

Canada's apartment rental market continues to be impacted by both shadow supply pressures from robust condo construction and the strong desire by young Canadians for homeownership. As noted in Chapter 4, homeownership among those under 35 has risen to new highs in Canada while hitting modern lows in the U.S. These divergent trends reflect both economic and lifestyle differences, resulting in less of a tailwind for the rental market in Canada compared to the US. With the growth of condo rentals, two distinct multi-residential rental markets have emerged in Canada: a traditional one dominated by low rents and aging product; and an emerging one dominated by lifestyle renters looking to lead the urban high-rise life without the commitment of ownership. Need-to-rent tenants typically seek affordability and tend to gravitate to older purpose-built apartments, especially those subject to rent controls. Meanwhile, the soaring supply of new condos is making the economics of renting increasingly attractive for lifestyle renters compared to ownership.

Institutional investors in Canada have struggled to meet their desired level of investment in multi-residential in recent years since the existing inventory of apartments in Canada is older, requires significant capital investment and trades at going-in yields that are significantly below commercial properties. With increased demand for urban lifestyle renting, the alternative for investors has been to develop new apartments with modern layouts and more amenities. This trend has led to an upswing in purpose-built rental apartment starts in 2015 with development reaching its highest level in 25 years. While quality purpose-built product continues to lease well, the continued delivery of "shadow rentals" in the condo market has recently contributed to a decline in "same store" condo rent growth in Toronto. As we have written for several years now, we continue to watch very carefully how the total supply of new apartments (both condo and purpose-built rental) interacts with potential demand and what kind of impact it may have on overall market rents in the sector.

"Investors must be very careful not to apply yields on "best of the best" properties to average to lower quality properties."

All told, we believe this is a time of transition for Canada. After an extended period of strong absolute returns and comparatively better performance relative to its peers, Canadian real estate faces more difficult conditions. Although Canadian real estate performed better than the highly volatile listed equity sector over the past year, and still provided comparatively better yields than bonds, returns are under potential downward pressure as NOI growth slows or even declines in some cyclical sectors like office. Offsetting some of the operating challenges are very strong capital demands from institutional investors as well as foreign investors who, at least in part, are attracted by the relative discount afforded by a lower loonie. We believe this could keep property yields for best in class institutional assets (outside of Alberta) stable in 2016. In this environment, where high quality assets are hard to come by, investors must be very careful not to apply yields on "best of the best" properties to average to lower quality properties. This makes it a challenge to meet market pricing as best in class properties continue to draw strong capital flows, while low and mid quality assets go through a period of price re-discovery. In this type of market, however, we ultimately believe that the expectations of investors can still be achieved by employing well-conceived investment strategies along with prudent, grounded execution. •

745 Thurlow Street, Vancouver BC
(owner: bcIMC)

Global Economy: Déjà vu?

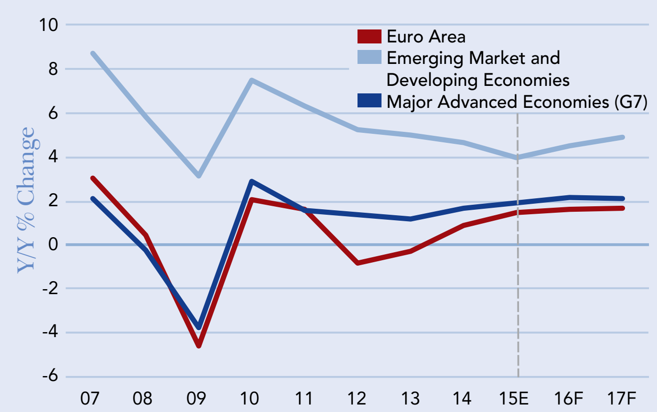
In last year's Perspective we discussed how the "New Normal" of sluggish growth, lack of inflation, persistently low interest rates and intense financial market volatility, would be recurring themes for investors. This proved quite prescient. Just as Greece-related economic concerns were essentially put to rest in 2015, financial markets began to reel as attention shifted to the challenging slowdown and policy missteps in China; tumbling commodity prices; the direction of the Federal Reserve and ultimately, the sustainability of global growth. It's almost like déjà vu.

"In an inversion of the events leading to the Financial Crisis, larger advanced economies are expected to support global growth in the near term as emerging and developing economies now deal with their structural issues."

Although China's slowdown was not unexpected, the speed and pace of its deceleration remains highly uncertain, especially since so much depends on the policies implemented by authorities in a centrally-planned economy. Financial markets are most concerned that recent stimulus measures in China are addressing internal imbalances such as financial sector vulnerabilities and a high debt overhang, created in part by previous stimulus programs. This calls into question whether Chinese officials can successfully rebalance their economy away from public investment into private consumption without incurring a "hard landing."

Whether one believes recent Chinese official statistics of 7% growth, China's transition will take time and will mean considerably lower growth than the 10%+ rates seen over the last decade. Since the Chinese economy accounts for the second largest share of global GDP, its transition is ultimately weighing on the world economy. Indeed, global GDP growth this past year was estimated to be the weakest since the Great Recession, largely due to the slowdown in China.

Fig. 2.1
Annual Real GDP Growth Outlook



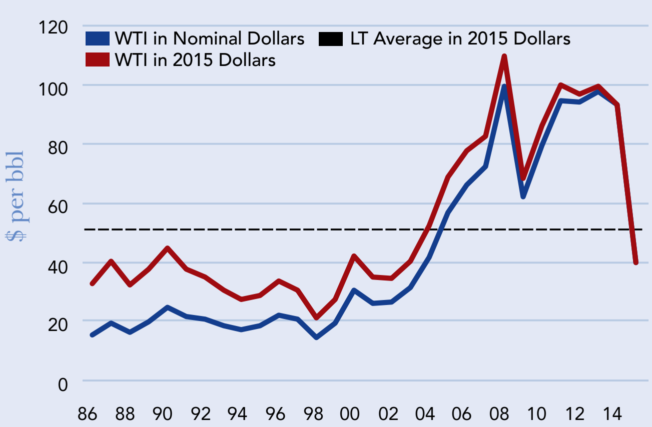
Source: IMF; October 2015 Forecast

Commodity prices tumble

Fears surrounding the health of the Chinese economy, as well as other emerging markets like Russia and Brazil have contributed to a major rout in commodity prices with lows in 2015 not seen since the Global Financial Crisis. Both base metals and agricultural commodity prices have been hit hard over the past year but it has been the 50%+ plunge in crude oil prices since the summer of 2014, that has been most surprising to financial markets.

While slower global demand has certainly contributed to oil's massive fall, we highlighted in last year's Perspective that a major factor has been a growing glut of supply. Thanks to OPEC's reluctance to cut production quotas and the shale revolution in North America which has significantly increased supplies of non-traditional product, the world has simply become awash in oil. Although U.S. shale production has eased, many forecasters believe that supply and demand forces will keep the real level of oil prices below its long term average of $50/bbl over the next few years (see Fig. 2.2) – a surprising turn of events considering that it was just eight years ago when "peak oil" theories and prognostications of $200/bbl were at their zenith.

Fig. 2.2
WTI Oil Price



Source: IMF, Bentall Kennedy

Two notable casualties of the commodity price downturn have been the resource-dependent advanced economies of Canada and Australia. Coming out of the financial crisis several years ago, both countries were among the strongest performers in the advanced world, benefitting in part from a rebound in commodity prices on the back of a stimulus-driven Chinese economy. But with commodity prices sinking, both Canada and Australia have suffered significant "terms of trade" shocks[1], slumping currencies and a sharp reduction in investment intentions. This sudden deterioration in economic conditions prompted central banks in both countries to cut interest rates in 2015, moves which have placed additional downward pressure on their currencies but also inadvertently provided further support to their already very robust housing markets.

The main intent of these looser monetary conditions is to support a transition of growth drivers to other sectors of each economy. In particular, Canada's large non-commodity export sector is expected to reap the benefits of both a lower exchange rate and growing demand in its largest trading partner, the U.S. (see next section).

Larger advanced economies lead the way

With much of the global economy struggling, larger advanced economies have been holding up comparatively better, supported mainly by strengthening domestic fundamentals. In fact, robust job gains and tightening labour markets have led to rising wage growth in both the U.K. and U.S. In

[1] The "Terms of Trade" is the ratio of export prices to import prices. When export prices fall sharply relative to import prices, this shock results in a significant loss of capital for a country.

an inversion of the events surrounding the Financial Crisis eight years ago, these advanced economies will likely be the pillars of global growth in the near term as emerging and developing economies now deal with their internal structural issues.

While by no means out of the woods yet, conditions in other advanced economies such as the euro area are also gradually improving. With a new Greek bailout deal in place, there is some optimism that the euro area is finally moving out from under the shadow of the sovereign debt crisis. Recent increases in bank lending within the region may be evidence of this while progress is also being made on bringing euro area unemployment down from double-digit levels.

Unemployment is already very low in Japan but that country's main economic concern has been the threat of deflation. Japan's poor demographics are arguably a major contributor to this risk and their recent experiment with Abenomics (a combination of stimulative monetary and fiscal policies) has yet to help, with overall Japanese economic growth contracting once again in Q3 2015. As a result, aggressive stimulative policies in Japan appear to have no end in sight. Similar deflation risks are also still very much apparent in the euro area despite the progress it has made over the past year. As such, EU policy officials are equally committed to maintaining aggressive monetary actions, including quantitative easing (QE).

A diverging world

The stimulative monetary actions of these key central banks, as well as in China, Australia and Canada, stand in sharp contrast to the Federal Reserve in the U.S. With the U.S. economy gaining traction (see next section), the Fed was able to deliver its first rate hike in almost a decade in December. Together with the termination of QE a year earlier, markets and investors have received confirmation that the Fed is finally beginning down the long road of normalizing monetary conditions in the U.S. Although this tightening cycle is starting from essentially zero with monetary conditions still highly accommodative, the divergence in policy direction between the U.S. (and possibly the U.K.) with the rest of the world is a key economic theme for investors.

One major implication of this theme (and one we briefly touched on in last year's Perspective) is that the flood of excess liquidity in the rest of the world would find its way to the U.S. in search of not only a safe haven, but comparatively better returns. The ensuing surge in demand for U.S. assets over the past year, particularly commercial property, is certainly a reflection of what some have called the "exceptionalism" of the U.S. economy. But there are major economic consequences to this. In particular, strong capital flows into the U.S. have caused a sharp rise in the USD against its trading partners, which is creating a very difficult environment for U.S. exporters. It has also raised the broad possibility that the U.S. is importing disinflation from the rest of the world.

These risks, along with the slowdown in emerging markets, the commodity price rout, and the constant potential for geopolitical flare-ups have the capacity to continue spooking global financial markets just as they have done over the past year. As such, we believe that the Fed will tread on a very cautious path with its tightening cycle going forward. This is also ultimately why we expect that the "New Normal" theme of low growth, low inflation, heightened volatility and low interest rates will persist for several more years.

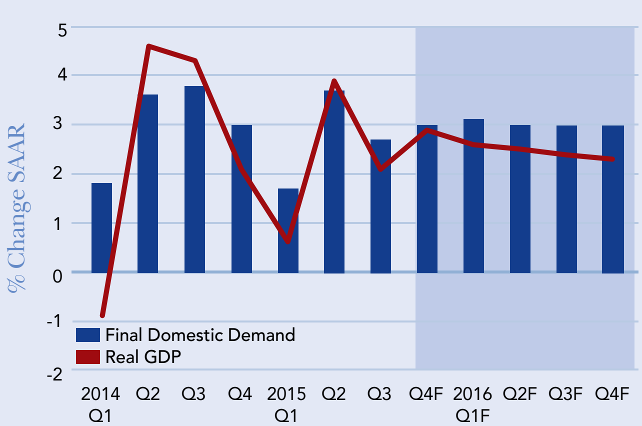
United States

Domestic fundamentals are strong

Even though the fallout from the decline in oil prices and the struggling global economy intensified in 2015, economic momentum has remained largely on track in the U.S. Following a temporary soft patch early in the year, U.S. real GDP growth has continued to trend near an average annualized rate of 2.5% in 2015 with final domestic demand (defined as consumption plus government spending plus gross fixed investment) tracking at an even better 3% (see Fig 2.3). Leading the domestic charge has been the American consumer, who appears to have left the shackles of the Financial Crisis firmly in the rear-view mirror. Consumer spending rates on everything from vehicles to clothing & jewellery are now roughly back in-line with pre-recessionary levels. And despite the pick-up in spending, U.S. household balance sheets are also about the best they have been in three decades as income gains continue to outpace consumer debt growth.

Fig. 2.3

Real U.S. GDP & Final Domestic Demand



Source: BEA; Forecast: BMO Nesbitt Burns Economics

While the significant cost savings of lower gas prices have definitely been a boon to American consumers (and the U.S. economy in general, since it remains a net importer of oil) much of the vigour in spending has been underpinned by substantial improvements in the job market. Job gains over the past two years have put the U.S. labour market close to traditional full-employment levels with unemployment at a 5% rate at the end of 2015 – the lowest since 2008. Given the tightening labour market, nominal wage growth has picked up, particularly in U.S. "innovation markets." These regions are typically dominated by the technology sector and have a high percentage of young educated workers in their labour force. A key point to note is that these innovation markets have expanded considerably beyond their pre-recession highs and are experiencing rapid urbanization while some other U.S. markets are still struggling to regain those prior peaks.[2]

The U.S. housing market is also broadly showing signs of heating up, with existing home sales continuing to break through new post-recession highs. An even more encouraging sign for the real estate sector is that U.S. household formation is trending strongly upward again particularly in the innovation markets noted above. According to the Census Bureau, there were over 1.6 million households created in the U.S. between the second quarter of 2015 and the same quarter a year earlier – the best pace since 2006. So far, the majority of these households have become renters and this has been a solid tailwind for new apartment development in key urban markets. Residential construction is still running behind the rate of household formation and especially so within the rental segment, where vacancies remain near

[2] For a detailed discussion on U.S. regional conditions, please see our U.S. Perspective on Real Estate

30–year lows (see Fig. 2.4). This shortage of new supply relative to potential housing demand is likely to remain a fundamentally potent source of support for U.S. residential development over the next few years.

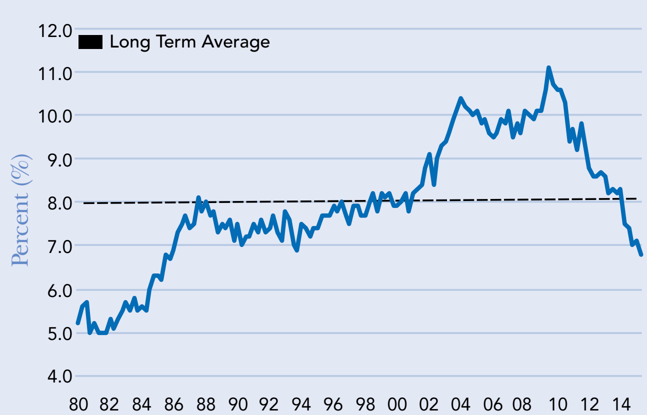
Can U.S. exceptionalism last?

Sustained domestic strength is critical to keeping the U.S. economy moving forward, particularly as the cycle grows longer in the tooth. Although it may not "feel like it" to some, the U.S. economy is entering its seventh year of expansion. Most cycles have historically lasted about ten years and so it should not be surprising that some sectors have lost momentum at this stage of the game. In particular, U.S. industrial production and manufacturing output began to soften over the second half of 2015. Leading indicators of manufacturing sentiment such as the ISM manufacturing index are also suggesting fatigue (see Fig. 2.5).

Part of the industrial slowdown story relates to the stubbornly high USD and softer global demand, all of which are having a direct negative impact on U.S. exporters. (The reduction in domestic oil production because of lower oil prices has also been a factor behind the drop in U.S. industrial production.) However, exports only make up a relatively small share of U.S. GDP and as pointed out in last year's Perspective, they do not have the capacity to derail U.S. growth single-handedly.

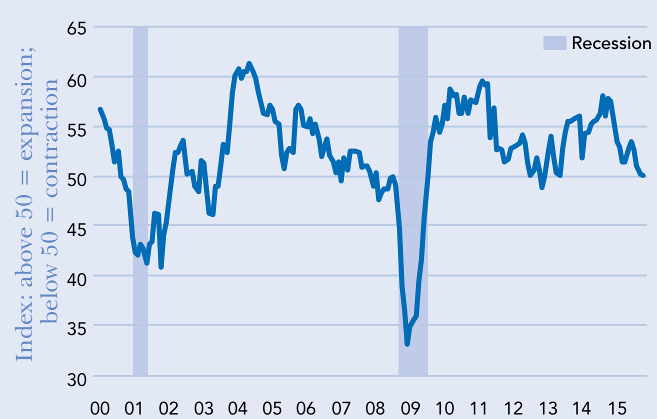
But the more tenuous external environment still poses material downside risks for the U.S. economy through other indirect channels. One key channel is the flaring up of global financial market volatility and its potential to bruise the psyche of U.S. consumers. The bull market in stocks since 2009 has been an instrumental factor in driving up the so-called wealth effect—the positive impact on consumer spending from improvements in household wealth. However, recent stock market corrections due to global worries about China's slowdown, could work in the other

Fig. 2.4
U.S. Rental Vacancy Rate



Source: US Census Bureau

Fig. 2.5
U.S. ISM Manufacturing: PMI Composite Index



Shaded Area = Recession

Source: Institute for Supply Management

direction should equity prices fail to meaningfully recover lost ground or even worse, contract by more.

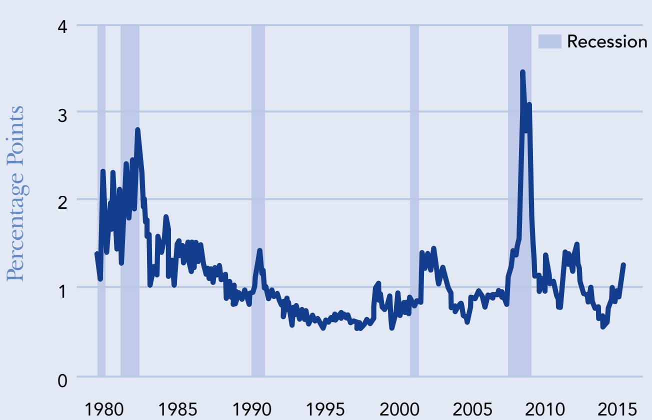
Global concerns, particularly the fall in oil prices, have also triggered an increase in U.S. corporate bond spreads (the difference between the interest rates paid by governments and blue-chip companies and those paid by riskier borrowers). Rising spreads have historically been a harbinger of economic downturns (see Fig. 2.6) because it implies tightening credit conditions and strained corporate balance sheets. To be sure, the emerging financial stresses in the U.S. are mainly centred in the petroleum sector and with those companies that have strong ties to the Chinese economy, so in this case "one swallow doesn't make a summer." But as the Great Recession has shown us, stresses in one industry or part of the world, certainly have the capacity to bleed onto other sectors and regions fairly quickly.

The Fed walks a fine line

Faced with continued strength in domestic demand, the Federal Reserve finally moved from zero and delivered a modest interest rate hike of 0.25% at the end of 2015. It has been nearly a decade since U.S. policy rates last increased, and there are some pundits who believe that the Fed may be "behind the curve" given that the U.S. economy is already in the advanced stages of an expansion. Since monetary policy works with a lag, the risk they see is that the Fed will need to play catch up in fulfilling its mandate of balancing growth with stable inflation. Indeed, wages are already on the verge of growing by 3% or more while many asset prices have risen sharply and are sitting at historically frothy valuations. Moreover, some believe that the prolonged period of abnormally low "emergency level" rates has had the unintended consequence of reducing liquidity in short term money markets as investors engage in greater risk taking activity by chasing yield in other sectors.

We believe, however that the Fed will not be in a hurry to pursue subsequent hikes and will take a very measured, drawn out approach to normalizing interest rates. There are two key reasons for this. First, we noted earlier that the Fed is the only major central bank in the world to have started rate hikes and this continues to draw strong capital flows into the U.S., resulting in a historically high trade weighted U.S. dollar. Since the U.S. is a major importer, the strong dollar is effectively contributing to the suppression of inflation in the U.S. (see Fig. 2.7) –

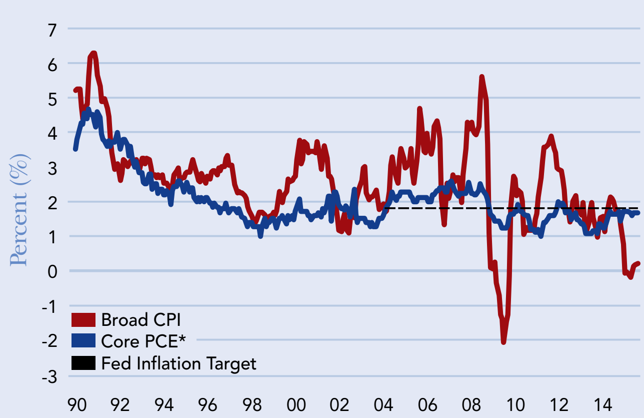
Fig. 2.6
Corporate Bond Spreads*



*Difference in yield between U.S. Aaa and Baa corporate bonds

Source: Moody's, US Federal Reserve

Fig. 2.7
Measures of U.S. Inflation



Source: Federal Reserve; *Excludes food and energy so much so that there is a risk the U.S. is actually importing "disinflation" from the rest of the world. As long as other central banks remain committed to excess monetary stimulus, every subsequent Fed rate hike would conceivably exacerbate this situation. Second, the Fed remains mindful that their singular actions have the capacity to jolt global financial markets and disrupt economic stability abroad but also at home. For these reasons, we think the pace of Fed tightening will not only be gradual, but that the "end point" for policy rates may be lower than it has been historically.

Canada

A two speed economy?

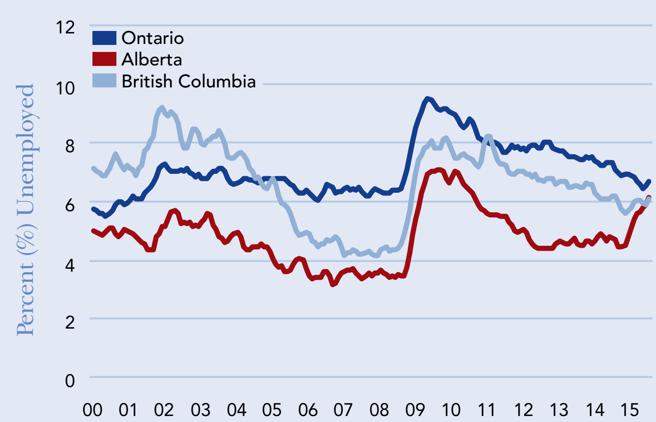
The massive plunge in oil prices during the past year dragged Canada's overall economy into a mild technical recession (defined as two consecutive quarters of negative growth). Oil-led weakness was concentrated mainly in business investment, as capital expenditures in machinery and equipment as well as mineral exploration were both hit hard. The terms of trade shock from the oil collapse also impacted national income as corporate profits and government royalty revenues fell sharply. Regionally, the energy-dependent provinces of Alberta, Saskatchewan and Newfoundland, took the brunt of the shock, with employment in each respective region also falling in 2015.

But other parts and regions of the Canadian economy, while certainly not booming, fared comparatively better. In particular, consumer spending and residential investment continued to moderately grow, particularly in Ontario and BC. Exports, mainly of non-commodities, also saw modest improvements. Considering the extent of the oil shock, Canada's overall labour market also remained resilient with the national unemployment rate only increasing by a fraction to 7.1% at the end of 2015. Much of this was due to regional differences as rising unemployment in Alberta was generally offset by stability in Ontario and BC (see Fig 2.8)

As we pointed out in last year's Perspective, a rotation of growth drivers away from natural resources is vital for the Canadian economy going forward. This is especially true since commodity prices and oil in particular, are not expected to recover to levels that will encourage significant new investment anytime soon. Moreover, the U.S. government's recent rejection of the Keystone pipeline means that even existing Canadian oil production will find it difficult to make its way to American markets over the longer term.

Although the rotation is likely to take time, we believe that it should ultimately bring annualized

Fig. 2.8
Provincial Unemployment Rates*



* 3 Month moving average

Source: Statistics Canada

economic growth rates in Canada back to a more moderate 2% level from the relatively weak 1% level experienced over the past year. The rotation should also provide several new areas of opportunity for real estate investors.

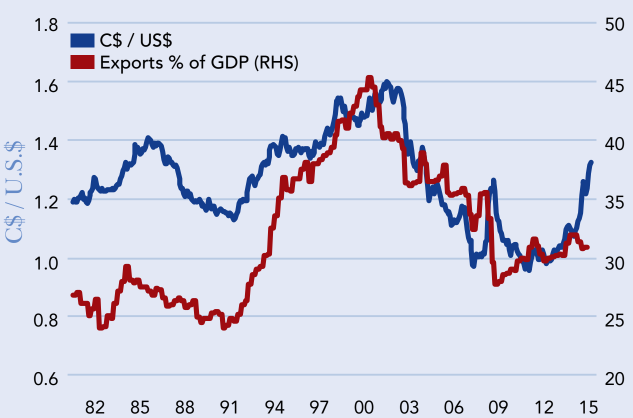
Non-commodity exports to dominate

Unlike the U.S., exports make up a considerable portion of Canadian GDP (about 30%) and it is this segment of the economy that is expected to take up the mantle of growth going forward. While a moderate improvement in exports was evident by mid-2015, we believe the shift towards export-led growth, particularly in non-commodities, has room to grow. That's because various hedges and long dated contracts have prevented many Canadian exporters from feeling the full benefits of the almost 30% depreciation of the loonie so far. Moreover, the prospects of further declines in the loonie (see below) combined with the sustained strength of U.S. domestic demand and Canada's recent signing of a new Trans-Pacific Partnership trade deal, should conceivably drive export's share of the economy to levels not seen since the 1990s (see Fig. 2.9).

To be sure, traditional export-oriented sectors like manufacturing are not expected to be as big a player in this transition since much of the activity in this industry permanently moved to low cost jurisdictions like China, Mexico and the southern U.S. during the past decade. But a weaker loonie should still have a noticeably large impact on a number of other non-commodity export sectors including consumer goods (such as pharmaceutical products) and services. This latter category, which has seen significant secular growth since 2000 (see Fig. 2.10) is also highly responsive to currency movements and includes some key real estate-using activities such as U.S. branch office investment (including R&D and call centres) as well as tourism.

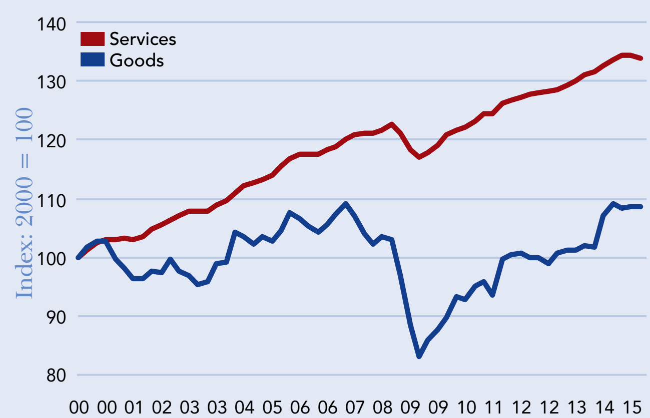
The biggest regional beneficiaries of the adjustment towards export-led growth will continue to be Ontario, Quebec and BC, whose economies have a high exposure to U.S. trade and tourism. Ontario's potential return to regional growth leader is especially notable, since the previously high C$, high oil prices and weak U.S. demand, caused Canada's most populous province to trail the national average in both output and job growth for much of the last decade.

Fig. 2.9
Canadian Exports & C$



Source: Statistics Canada; Bentall Kennedy

Fig. 2.10
Real Canadian Exports



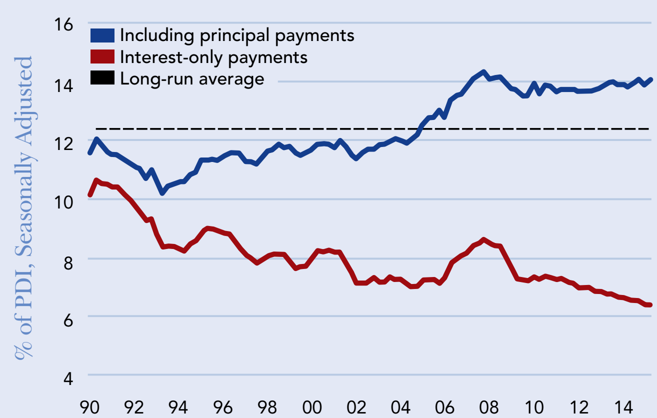
Source: Statistics Canada

Consumers and housing holding up

The transition to export-led growth is also vital since Canada's household sector cannot be relied upon to carry the weight of the economy indefinitely. As mentioned earlier, both consumption and housing once again produced decent gains over the past year thanks largely to lower interest rates. But a major implication is that Canadian consumer debt burdens have continued to rise to new heights amidst relatively sluggish income growth. As a result, debt servicing costs have taken up an increasing share of household budgets (see Fig. 2.11). In the absence of a material increase in incomes, debt servicing is likely to constrain the degree of discretionary spending in Canada going forward, particularly if and when interest rates rise.

Although ongoing strength in housing has been partly driven by healthy population growth and increased urbanization, a number of fundamental imbalances

Fig. 2.11
Debt Service Ratio (Principal and Interest)



Source: Statistics Canada; RBC Economics Research

5875 Explorer Drive, Mississauga
(owner: BK Prime Canadian Property Fund Limited Partnership)

have also developed in this sector. For example, typical home price valuations like price to income metrics have become excessive in two key markets – Vancouver and Toronto (see Fig. 2.12). Meanwhile, the record level of multifamily development (see Fig. 2.13) is increasingly catering to speculative condo investors rather than user-occupiers. As a number of international commentators including the OECD and IMF have recently remarked, the more these imbalances grow, the greater Canada is at risk of a sharp housing correction in the future. In fact, Canada's financial services sector has been bracing for a potential slowdown in housing and lending activity by engaging in various cost-cutting measures over the past year.

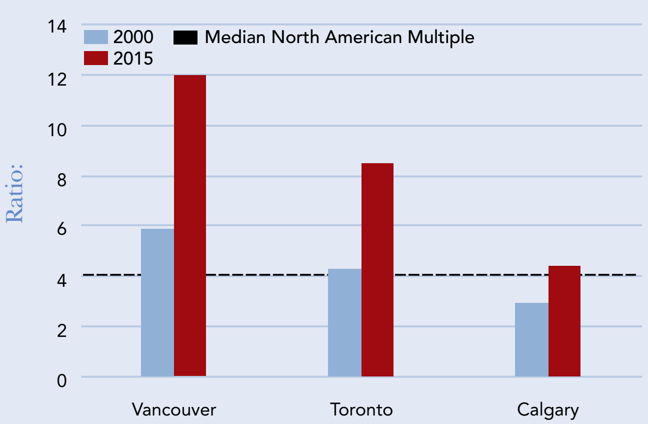
However, with interest rates remaining at very supportive levels and unemployment rates not expected to materially rise (outside of the energy patch), we believe that a "soft landing" rather than a U.S.-style capitulation, is still the most likely outcome for Canada's housing market.

Policy to remain stimulative in Canada

Last year's oil shock prompted two surprise interest rate cuts by the Bank of Canada. Although the cuts re-ignited consumer spending and housing, it was mainly intended to support exporters by putting additional downward pressure on the loonie. Of course, for those sectors with high U.S. import content such as retail and distribution (as well as vacationers to the U.S.) the lower loonie has driven up their costs. But the Bank of Canada believes that on net, the stimulative benefits of a lower loonie on the economy outweigh those costs. To that end, most forecasters expect the Bank to remain very dovish as it keeps policy rates in Canada at very low levels. With the U.S. Fed having begun a rate hiking cycle, the divergence in monetary policy direction in North America could potentially result in further declines for the loonie with some expecting it to slip into the mid 60 US cent level before mid-year.

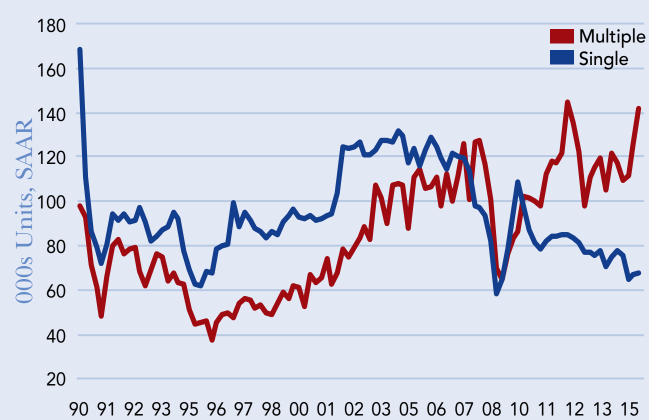
Canadian fiscal policy is also expected to be more stimulative. A recently elected new federal government in Canada received a mandate to increase spending over the next few years, particularly on infrastructure in the country's biggest cities. While this is likely to result in a few modest federal deficits over the next few years, it should have a broadly positive impact on economic growth in the near term and be quite beneficial to real estate investors over the long term. As we have discussed in the past, real estate investments rely on high quality infrastructure – including transportation, utilities, and telecommunications – to help sustain long run value. •

Fig. 2.12
Median Home Price to Median Family Income Ratio



Source: Statistics Canada; CREA; Demographia; Bentall Kennedy

Fig. 2.13
Canadian Housing Starts By Type



Source: CMHC

Tour KPMG & Promenades Cathédrale, Montreal, QC
(owner: Prime Canadian Property Fund)

Bentall V, Vancouver BC
(owner: Prime Canadian Property Fund
together with other Bentall Kennedy clients)

Investment Summary

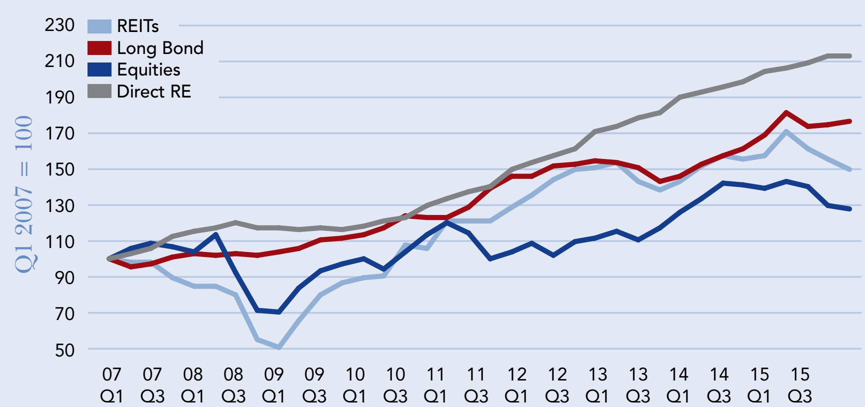
The REALpac / IPD Canada Property Index for standing investments posted a total return of 7.2% in the twelve months ending September 2015. This was down slightly from 9.1% a year earlier and the lowest annual return for the IPD Canada Property Index in five years. The IPD Canada Property Index also trailed its U.S. counterpart – the NCREIF NPI – for a second year in a row. The NPI posted a total return of 13.5% in the twelve months ending September 2015 – its best result since 2011.

Despite the weaker performance in 2015, private real estate investments in Canada significantly outperformed publically traded asset classes over the past year. For example, in the twelve months to September, Canadian equities as measured by the S&P TSX Index produced a total return of –8.4% due mainly to heightened global worries over China and the collapse of resource prices, particularly oil (See Fig 3.1). This was the worst performance for equities since 2011.

Meanwhile, the Canadian REIT sector, which is sometimes seen as a leading indicator of the private real estate market, was caught up in the broader stock market weakness. It posted a total annual return of -4.7% in 2015 similar to the negative results Canadian REITs produced when the "Taper Tantrum" hit the sector in 2013 (see Public Equity section). It should be mentioned that the REIT sector downturn during that year failed to foreshadow a similar slump in the private property market. Instead, REITs (along with other public equities) recovered in the subsequent year, resulting once again in greater volatility than the direct real estate market – see Fig. 3.1

"A heavy weight of capital for direct real estate continues to drive an imbalance between the demand for high quality property investment product and available supply."

Fig. 3.1
Cumulative Total Returns By Asset Class



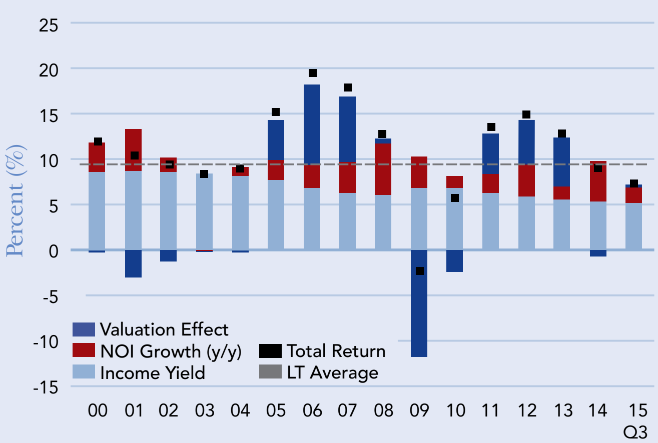
Source: Haver Analytics; Bentall Kennedy

Income yields at all-time lows

IPD Canada income yields effectively held steady in 2015, moving to 5.2% in Q3 2015, from 5.3% a year earlier – see Fig. 3.2. Similar to the trend in government bonds and mortgages (see Debt Market section), real estate yields were at their lowest level on record in 2015.

Although income yields modestly compressed, it was largely the weaker pace of capital appreciation that drove total real estate returns in Canada lower during 2015. For example, the change in capital values for standing properties during the twelve months to September 2015 was just 2%, down from 3.6% during the same period a year earlier. This is also the lowest rate of annual capital growth since 2010 when values were still contracting due to the Financial Crisis.

Fig. 3.2
Decomposition of IPD Canada Total Return



**12 Months Ending In Q3 Of Every Year* *Source: IPD Canada; Bentall Kennedy*

The slowdown in capital growth was almost entirely because of soft property net operating income (NOI) growth. In Q3 2015, year-over-year NOI growth as measured by the IPD index increased by just 1.7% with only the retail sector faring better than 2% (See the Space Markets section). NOI growth as of Q3 2015 was also down materially from 4.3% during the same period in 2014 although it was slightly better than the 1.5% increase noted in 2013. Over the past five years the annual rate of NOI growth in Canada as measured by the IPD index has actually been relatively choppy, showing no clear direction in trend – see Fig 3.2.

The other contributor to capital growth, the valuation effect (the value adjustment arising from changes in capitalization rates) was mildly positive in the twelve months to Q3 2015. Fig. 3.2 shows an increase of 0.2% during this time period, in contrast to the 0.8% decline the year before. The modest improvement in the valuation effect suggests that cap rate compression was still a mild tailwind for institutional quality Canadian real estate at the end of 2015 despite our view in last year's Perspective that its positive effects had run its course. To be sure, we highlight below that strong demand for very high quality properties may have led to further cap rate compression in these particular assets, resulting in a highly bifurcated investment market in Canada. [1]

Flight to quality

In the last few issues of Perspective, we discussed how the potent combination of significant liquidity in the capital markets and ultra-low interest rates created very robust demand conditions for Canadian real estate. These supportive demand forces remained very much in place during 2015 although transactions for institutional-grade properties continued to ease during the first half of the year –

[1] Note that a majority of properties in the IPD Canada index are not revalued until the fourth quarter of each year. This can result in valuation effects in the index that often lag market conditions. Based on the transactions we observed over the past year, the positive valuation impact may be even slightly larger by the time Q4 2015 data is reported.

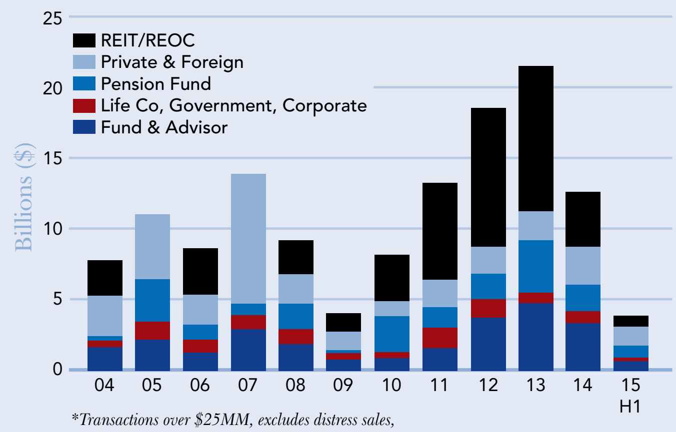
see Fig. 3.3. Given the underlying pace of activity, full year transaction volumes in 2015 may be the lowest since 2010.

A major factor impeding the velocity of investment activity in Canada has been the scarcity of high quality offerings. While a robust pricing environment would usually be a strong incentive to draw out potential sellers, a lack of reinvestment opportunities appears to have inhibited many vendors from offering product.

The resulting imbalance between the heavy weight of capital seeking real estate and available supply continues to support generally stable property values and cap rates in Canada, despite the recent deterioration of economic and property market fundamentals (see the Space Market section). Even oil-ravaged office markets in Alberta, which are experiencing significant uncertainty due to sharply rising vacancy and falling rents (See the Regional Overviews section), have seen transactions stall as landlords (many of whom are well-capitalized institutions) simply adopt a "wait and see" approach. As a result, cap rates in Alberta have only increased slightly in 2015, but given the distress in the office leasing market, it is only a matter of time before we see more material increases.

Softness in underlying market conditions in Canada, however, is causing many investors to take a "risk off" approach with their acquisition strategies, creating a bifurcated investment market. For example, some of the best quality properties that traded in 2015 experienced aggressive demand as their cap rates compressed below the 5% level.   We believe this "flight to quality" dynamic in which investors show a strong preference for perceived "safe and stable" assets, could further divide the market along the lines of core and secondary/opportunistic properties. As we discuss in greater detail below, prime assets in highly desirable areas could conceivably attract even higher pricing and lower cap rates in 2016, while reduced liquidity is experienced in weaker quality offerings.

Fig. 3.3
Canadian Real Estate Volumes By Purchaser*



*Transactions over $25MM, excludes distress sales, trades between partners, non-arms length trades and any other type of non-market sale

Source: RealNet, RBCCM

Competing costs of capital

Investment conditions in Canada are also being shaped, as always, by competing costs of capital. REITs and REOCs have been prominent purchasers of Canadian real estate, especially in the post-recession period, powered largely by ultra-low interest rates. But as discussed in the Public Equity section, capital raising by this group became more muted over the past two years, partially reflecting the recent negative market sentiment for this interest rate-sensitive sector. This has resulted in a growing disconnect between current REIT share pricing and the value of their underlying properties. It has also made life difficult for REITs looking to make accretive acquisitions and grow their operations.

While REITs were less active in the investment market in 2015, foreign buyers, especially from China, are emerging as an important (albeit still comparatively small) buyer group in Canada. To be sure, affluent private Chinese households have been actively buying residential properties in Canada for a number of years. But in 2015, the prices paid by some

Table. 3.1
Canadian Pension Fund Investment Solely In Canada, 2014 (End of Year)

FUND SIZE (Net Assets)	FUND ASSETS ($MM)	CANADIAN RE EQUITY ($MM)	% CANADIAN REAL ESTATE
BREAKDOWN OF CANADIAN PENSION FUND INVESTMENT			
Funds with Real Estate			
Top 10 Funds with Real Estate	1,112,461	97,272	8.7%
Other Funds > $1B	356,582	26,228	7.4%
$100MM to $1B	32,559	2,309	7.1%
$0 to $100MM	2,487	156	6.3%
Funds with Real Estate	1,504,089	125,966	8.4%
Funds without Real Estate	381,640	-	0%
All Funds	1,885,729	125,966	6.7%

Source: Canadian Pension Fund Directory; Bentall Kennedy

institutional Chinese investors on a few high-profile commercial real estate deals garnered considerable attention.

The growing impact of Chinese institutional capital in Canada is part of a bigger global trend. Faced with economic uncertainty at home and a government that has lifted a ban and relaxed laws regarding overseas investment, institutions from mainland China and Hong Kong have been hastily placing capital in select foreign cities they are highly familiar with. This list has included mega cities such as New York and London but now increasingly Toronto and Vancouver as well. Based on recent trends, we believe foreign capital, (including Middle-East, European and Chinese) could be a larger force in the Canadian commercial real estate market in 2016. The sheer volume of capital some of these investors are required to invest and the nature of their required returns could suggest a very aggressive approach to investing by some, even though they might not have any in-house knowledge or local market expertise. While this could drive them to eventually partner with a domestic manager who can help them better navigate the market in this country, it could also contribute to even higher valuations and a further compression of yields for top properties in the near term.

Institutions committed to real estate

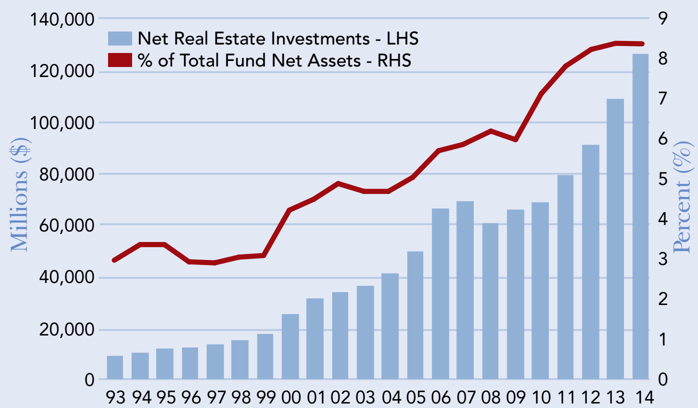
As frequently discussed in past issues of Perspective, domestic institutional investors (including pension funds, endowments and life insurance companies or Lifecos) have been formidable commercial property investors and remain a dominant source of capital for the asset class in Canada. For example, the net invested equity in Canadian real estate by domestic pension funds grew to over $125 billion at the end of 2014 – see Table 3.1. This is up 16% from just the previous year and almost double the level of pension fund investment in real estate prior to the Great Recession.

Recent growth in institutional investment in commercial property has occurred for two key reasons. First, heightened volatility in public markets has motivated many of these investors to "de-risk" their portfolios by reducing allocations to listed equities and shift into more stable, private assets with predictable cash flows. Second, many of these funds are pursuing liability-driven investment (LDI) strategies and income-producing real assets like private real estate and infrastructure are viewed as a natural fit. That's because the long dated payout obligations and limited liquidity requirements of these funds result in a structurally low cost of capital in such assets. Investments in direct real estate are also essentially seen as providing inflation-hedging and diversification benefits, which helps these funds to manage risks and potentially earn excess returns.

The typical allocation ranges that institutions have targeted for real estate has varied. For example, many large pension funds who were "early adopters" of real estate (having directly accumulated some of the best properties in Canada over the years) are attempting to take their allocations from 10-15% up to as much as 20%. Meanwhile, small and medium sized institutional investors, many of whom are just beginning to embrace real estate, have mandates to take what are effectively negligible real estate allocations up to the 5-10% level.

The current investment environment, however, has made it challenging for these investors to ramp-up their exposure to real estate. For example, Fig. 3.4 shows that the percentage of total pension fund assets invested in Canadian real estate in 2014 remained essentially flat at 8.4%. Part of this allocation issue is due to the "denominator effect" as rising values in nearly every asset class over the past few years has contained the relative share of real estate in their portfolios. However, another major factor, which was mentioned above, is that acquisition opportunities in Canada, particularly of high quality core properties, have been harder to come by.

Fig. 3.4
Canadian Pension Fund Investment in Real Estate



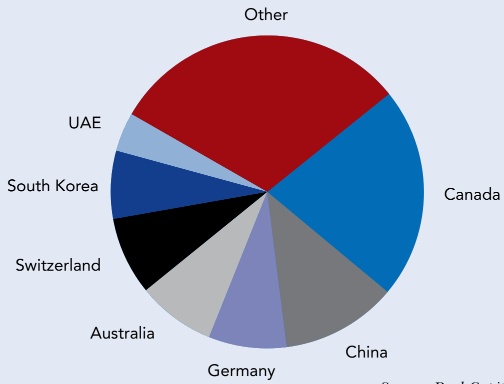
Source: Canadian Institutional Investment Network, Various Financial Statements

Lower expectations or take on more risk

In order to successfully compete for these limited real estate opportunities, particularly in an environment of low growth and low interest rates, institutional investors in Canada have been increasingly forced to adjust their overall return expectations. With going-in yields for core properties at 5% or less at the end of 2015 and capital appreciation waning, the double-digit returns achieved by Canadian real estate in the past will be very tough to achieve going forward. Lower expected market returns are not just a trend in real estate, but are likely in almost all other asset classes as well. This is part of the "New Normal" theme we outlined earlier in the Economics section.

However, an investment truism is that higher returns are still possible by taking on more risk. One higher risk strategy increasingly being used by larger pension funds is foreign investment. Although many of these funds remain committed to Canada (largely because their obligations are in Canadian dollars) with healthy domestic holdings in what they view as strategic properties, a number have been increasingly looking abroad to find more opportunistic yields and potentially stronger growth prospects. Some of these funds have not had to look too far. With a sizeable 30% share of the global real estate universe, a very transparent and liquid market, and a comparatively robust and dynamic economy, the U.S. has been high on the radar screen of Canadian investors. In fact, Canadians (mainly large pension funds) represented

Fig. 3.5
Cross Border Capital Flows Into The U.S. - YTD Q3 2015



Source: Real Capital Analytics

22% of the cross border capital entering the U.S. commercial real estate market during the first three quarters of 2015– see Fig. 3.5. This is by far the largest single source of foreign capital in the U.S. with a whopping $35 billion invested by Canadians since 2014 alone.

With the price of existing properties often exceeding replacement cost in Canada, development has also been viewed as a compelling higher risk strategy. New development has not only provided some real estate investors with significant alpha in recent years but it has also had the advantage of providing a new generation of high quality income-producing assets to portfolios that would be otherwise difficult to acquire.

Although development opportunities continue to exist in Canada, especially large mixed use projects in the country's biggest urban area's (see the Space Market section) a key question for investors is: how much broad opportunity remains on the table? This is an especially compelling question given the relative compression of development yields over the last few years and the non-trivial supply of new office and multi-family properties already being delivered in these markets.

Implications for Investors

Despite very robust pricing in Canada and record low cap rates, especially for best in class properties, real

Hillside Centre, Victoria, BC
(owner: Prime Canadian Property Fund)

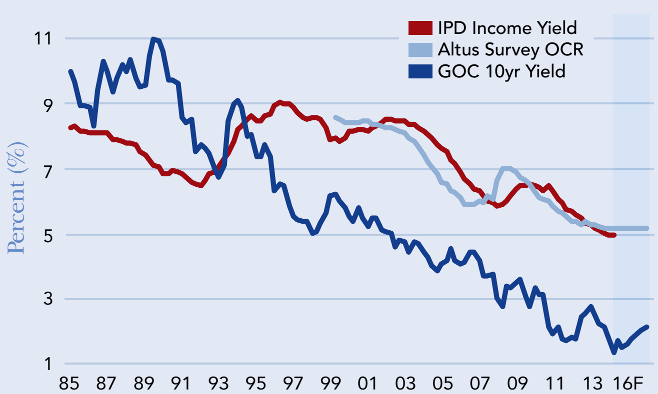
estate's yield spread with benchmark 10 year GOC bonds remained comfortably above its long term average of 290bps at the end of 2015 – see Fig 3.7. The main reason for this still generous spread is due to unexpected declines in interest rates through the year. At the risk of sounding like a broken record, the consensus expects interest rates to increase going forward, especially with the Federal Reserve starting to normalize policy rates in the U.S. While this will likely reduce real estate's spread to government bond yields, Fig. 3.6 shows that expected interest rate increases over the next two years will be mild and measured such that they will probably remain near historic lows. This is, once again, consistent with the "New Normal" theme outlined earlier.

As interest rates modestly rise, however, cap rates for lower quality properties could follow suit. This is partly due to weaker investor appetite (and consequently less liquidity) for these properties. Such a dynamic is exactly what we observed in mid-2013 when the market was spooked by the threat of higher interest rates following the Fed's announcement that it was going to taper its QE program.

But even if interest rates modestly rise in the near term, best in class cap rates in Canada could remain at their current all-time lows, if not drift lower. As discussed above, the major reason is the wall of capital competing for these high quality properties. Fig. 3.6 shows that current institutional quality cap rates certainly have more than enough room to absorb potential interest rate increases such that spreads may only return to the long term average.

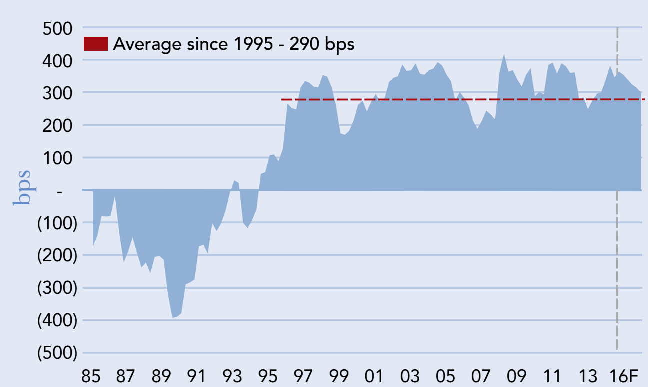
Although high quality properties could see some potential valuation gains in the near term, we remind investors that there is limited scope, more broadly, for significant capital appreciation. This is partly because slower economic growth in Canada and deteriorating property market fundamentals in some sectors are not likely to support broad NOI growth of much better than inflation over the next year or two. With low going-in yields of 4-5%, average total market returns are therefore likely to remain in the mid-single digits. Considering the stellar double digit returns Canadian real estate produced following the Global Financial Crisis, it would be entirely fair to view this adjustment as a "late stage mean reversion".

Fig. 3.6
Institutional Property Cap Rates & 10 Year GOC Bond Yield



Source: IPD Canada; Statistics Canada; Altus
Interest rate forecast: TD Economics as of Sept 2015;
Altus Survey OCR held constant at current 5.1% over forecast period

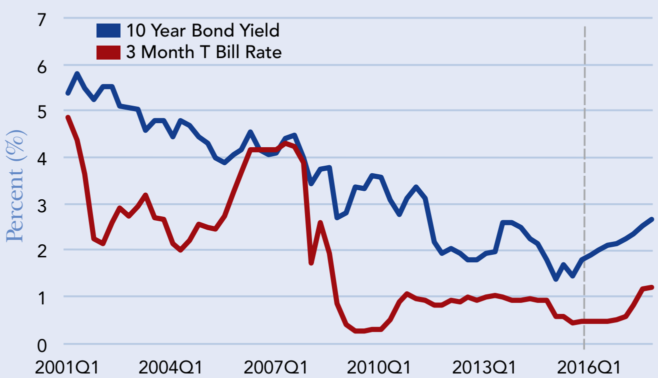
Fig. 3.7
Spread – Survey OCR & GOC 10 Year Bond Yield



Source: IPD, Altus, Statistics Canada, Bentall Kennedy;
Forecast: TD Economics interest rate outlook and income yield holding at current 5.1%

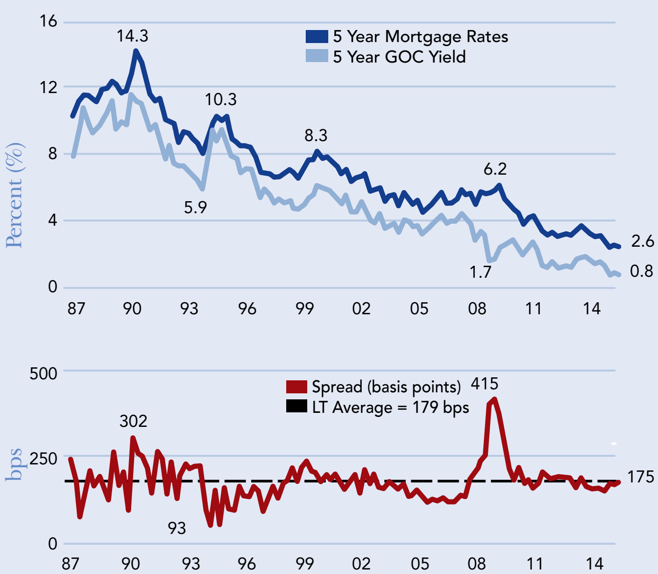
Debt Market

Fig. 3.8
Canadian 3 Month T-Bill Rate and
10 Year Government of Canada Bond Yield



Source: Bank of Canada;
Forecast: TD Economics (November 2015)

Fig. 3.9
5 Year Commercial Mortgage Rates vs.
5 Year GOC Bond Yield



Source: Thomson One; RBC Capital Markets

In what has been an on-going theme since the Financial Crisis, interest rates reached new lows again in 2015. Much of the reason for the decline was continued concerns over the global economy and the growing threat of disinflation, especially given the sharp fall in energy prices. As discussed in Chapter 2, short rates in Canada were also pushed lower due to two surprise cuts by the Bank of Canada – see Fig. 3.8.

Given the rotation of drivers occurring in the Canadian economy, due in part to the commodity shock, forecasters believe the Bank of Canada will refrain from raising rates until at least mid-2017. This should keep the short end of Canada's yield curve grounded near zero. However, persistent strength in U.S. domestic demand is expected to allow the Federal Reserve to modestly hike policy rates a few more times over the next two years. While this will not only increase the spread between Canadian and U.S. short rates in the near term, it is also expected to grind longer term bond yields on both sides of the border modestly higher. As such, forecasters expect that the ten year GOC bond yield could reach close to 3% by the end of 2017 (see Fig. 3.8). For context, this merely takes long rates back to 2013 levels, which are still "low" by historical standards.

Borrowing costs attractive amidst wider spreads

A key driver behind the fulsome valuations in Canada's property markets has been the availability and very attractive nominal cost of real estate debt. For example, the conventional five year commercial mortgage rate at the end of Q3 2015 was just 2.6%, about 25bps lower than a year earlier (see Fig. 3.9) – and the lowest ever recorded.

But these low borrowing costs were solely the result of historically low government bond yields and consequently, base rates. In contrast, an emerging story for real estate debt markets has been a widening of commercial mortgage loan spreads as broader corporate credit conditions across North

America deteriorated in 2015 (see Chapter 2). Given the more attractive relative value found in the corporate credit market, commercial mortgage spreads offered by balance sheet lenders (including chartered banks and lifecos) nudged up at the end of 2015 by 18bps from a year earlier, albeit they were still within long term averages and nowhere near the "blow out" conditions seen during the Financial Crisis in 2008.

A slight widening of spreads has also been seen on new 5- and 10-year multi-family CMHC insured loans at the end of 2015. However, this was largely due to limited availability as balance sheet lenders and Canadian Mortgage Bonds (CMB) filled the balance of their 2015 allocations.

In contrast, wider corporate credit spreads are starting to have a pronounced impact on the CMBS market. This relatively small lender segment in Canada, which generally caters to lower quality, non-core product, has actually seen renewed momentum since its recovery in 2012. However, CMBS spreads are largely dependent on the price at which issuers can competitively sell CMBS bonds in the overall credit market. With the up-tick in credit market spreads in mid-2015, CMBS lender spreads have become less competitive than balance sheet lender spreads. As such, CMBS issuance is likely to become more muted going forward and will likely remain that way until credit markets return to more normalized levels.

Widening corporate spreads have also reduced the attractiveness of unsecured debt as a source of capital for some borrowers such as REITs (see Public Equity Market section).

Olympic Village Residential, Vancouver, BC
(owner: Prime Canadian Property Fund)

Table. 3.10
Conventional Debt Market Parameters - Q3 2015

	MAXIMUM LTV (%)	LONGEST AMORTIZATION (YRS)	MINIMUM SPREAD OVER 5 YEAR GOCs
Downtown Class AA Office	71	26	184
Suburban Class A Office	67	24	199
Tier 1 Regional Malls	70	26	176
Multi-tenant Industrial	69	25	175
Suburban Multi-residential	77	28	112

Source: Altus Insite

Implications for real estate investors

As noted above, the all in costs for debt remains extremely attractive in Canada with conventional lenders such as banks and lifecos continuing to be active issuers of debt. As has typically been the case in Canada, these lenders have remained prudent in their underwriting with loan-to-value ratios and debt-service criteria remaining conservative and squarely within long-term norms – see Table 3.10. Borrowers of conventional loans have also been disciplined and not aggressively using debt to boost returns. As such, none of the excesses of the pre-Financial Crisis period appear to be evident.

It should be noted, however, that conventional lenders have become increasingly focused on "core" – this includes core assets, markets and clients. This is mainly because credit spreads now make up over 70% of their total lending rate, up from 30% in December 2007, indicating that "risk" is currently making up the majority of their returns. This has prompted these lenders to increasingly avoid markets, properties types and sectors in which they see potential systemic problems. For example, a majority of conventional Canadian lenders in 2015 shifted their focus away from financing condo construction in favour of investing in rental apartments over concerns that the soaring cost of land and record-high levels of household debt will push Canadians increasingly out of the housing market.

Conventional lenders have also grown nervous about lending in the Alberta market over concerns that the pain in the oil sector will continue to impact properties in that market. The shift away from Alberta will likely make Toronto and Vancouver the main beneficiaries as a vast majority of lenders express their desire to boost business in those two markets. In trying to grow their presence in Toronto and Vancouver, domestic lenders are likely to also face competition from foreign investors looking to expand their presence in these two globally recognizable Canadian cities, encouraged by the falling loonie and the country's reputation as a safe haven.

These competitive market conditions in "core" lending is another reason why we see cap rates for high quality institutional properties in Toronto and Vancouver remaining at their current lows or even compressing further in 2016. On the other hand, the focus of conventional lenders on core, their selective avoidance of Alberta, and the potential slowdown in CMBS issuance are all reasons why we believe pricing for secondary/opportunistic properties including those in Calgary and Edmonton will further diverge from core properties in Toronto and Vancouver. But less competitive conditions in the non-core part of the market (as well as in the subordinated debt space) could provide debt investors with opportunities for very attractive returns, so long as risks are appropriately underwritten.

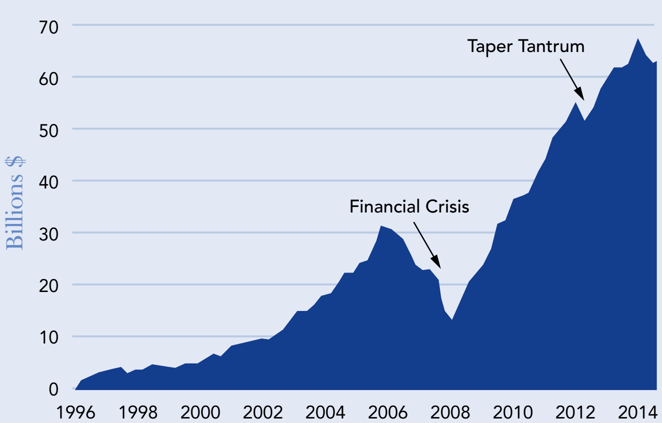
50 Bay Street, Toronto ON

Public Equity Market

Canada's listed property sector (REITs and REOCs) were largely held back by the broader equity market rout in 2015. After increasing by 10.4% the year before, total returns for the S&P/TSX Capped REIT index fell by 4.7%. While this was comparatively better than the Canadian equity market as whole, where total returns (as measured by the S&P/TSX Composite index) fell by 8.3% in 2015, it materially lagged the listed property sector's three and five year annual returns of -0.2% and 7.2%, respectively.

Canadian REITs and REOCs also underperformed their American counterparts in 2015, with the FTSE NAREIT All Equity US REIT index returning +2.8% (USD) in 2015. However, Canada's listed property sector outperformed ex-US global indices for a second year in a row. For example, the EPRA NAREIT Global ex-US index had a total return of -10.7% in USD terms in 2015 (although when similarly expressed in USD, Canadian REIT sector returns were significantly weaker at -20%.

Fig. 3.11
Market Capitalization of TSX-Listed REITs



Source: Thompson One, RBC Capital Markets

Equity capital raising slips again

As noted earlier in this chapter, the Canadian listed property sector was largely held back by negative market sentiment similar to what was experienced following the "Taper Tantrum" in 2013 when the Fed announced its intention to end QE. That the sector also performed poorly in a year when the Fed began to raise rates, is not entirely a coincidence. As we noted in previous issues of Perspective, investor sentiment for the Canadian listed property sector, and consequently its market performance, tends to be highly correlated with the perceived direction of interest rates and general capital market conditions.

Weaker share prices in combination with poor equity capital raising activity for a fourth consecutive year caused the market capitalization of the Canadian REIT sector to slip to below $60 billion at the end of 2015. This is down by over 10% compared to a year earlier – see Fig. 3.11. We noted in last year's Perspective that the slowing trend in equity raising was largely related to comparatively more attractive conditions in the debt market. While this certainly continued to be the case in 2015 as all-in costs for mortgages from balance sheet lenders fell to new lows during the year (see Debt Markets), REIT unsecured-debt issuance also materially slowed from its more voracious pace the year before.

Sector valuations at a discount

The softer pace of capital raising in the REIT sector (See Fig. 3.12) may be a reflection of two somewhat related developments. First, as we pointed out earlier, there has simply been a lack of acquisition opportunities, especially for larger REITs resulting in less need to raise capital. Second and perhaps more importantly, valuations in the overall sector have turned decidedly weaker making it difficult for some

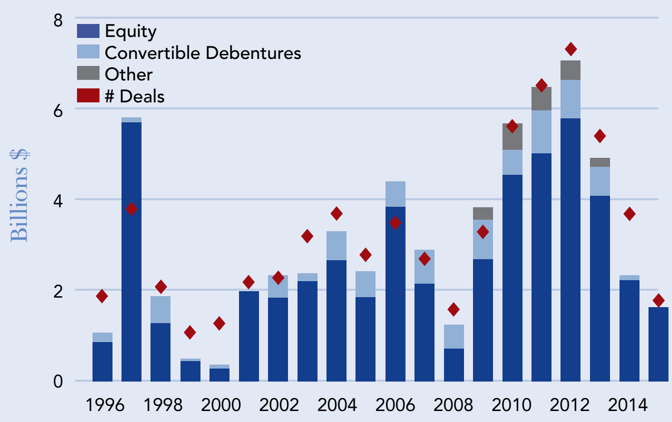
REITs to raise capital. That's because the pullback in REIT and REOC share pricing occurred even though cap rates and the market value of their underlying properties, remained generally steady.

RBCCM estimates that Canada's listed property sector traded at approximately an 11% discount to NAV at the end of the year.[1] This is well below the long term average premium to NAV of 3% the sector has typically seen. Other valuation measures, including average AFFO yields and sector yield-spreads to 10yr GOCs (as well as to corporate A bonds) similarly indicated that REITs and REOCs were trading at a non-trivial discount relative to history at the end of 2015 – See Table 3.13.

Some might attribute part of these weaker valuation results to the generally lackluster economic prospects for Canada given the collapse in oil prices (see Chapter 2). For foreign investors, this perception of weakness is further exacerbated by the sharp fall of the Canadian dollar, which has made Canadian returns much worse when viewed against the U.S. or other stronger currency countries.

While certain property sectors in Canada like office and retail are certainly facing headwinds from a growing disequilibrium in market conditions (see Chapter 4), it is important to note that most REITs and REOCs in Canada continue to experience moderate NOI growth from their properties. Meanwhile, their balance sheets, liquidity situation, payout ratios and general access to capital all seem to reflect a sector that, as a whole, remains fundamentally sound. As such, it is difficult to pinpoint exactly why the public market has been inclined to broadly undervalue the sector while property values in the private market remain comparatively robust.

Fig. 3.12
Annual REIT & REOC Capital Raising



Source: Company Reports and RBC Capital Markets

Table 3.13
REIT Sector Valuation Estimates

	2010	2011	2012	2013	2014	Long Term Average	Q3 2015
AFFO Yield (%)	6.4	5.9	5.5	6.7	6.9	7.5	7.2
Premium vs. 10yr GOC (bps)	325	398	375	394	509	356	573
Price/AFFO	15.7X	16.9X	18.0X	14.9X	14.5X	13.9X	14.0X
NAV Premium (or Discount)	8%	4%	3%	-8%	-5%	3%	-11%

Source: RBCCM

[1] Independent pricing of assets reflecting observed cap rates in the market is typically used to estimate NAVs in the listed property sector.

Implications for investors

From the perspective of the listed property sector, the main implication of the disconnect between share prices and underlying property values is that it has made it difficult for many REITs and REOCs, particularly newer ones, to make accretive acquisitions and grow their operations. As we pointed out earlier, this development has generally caused the listed property sector to become less of a force in Canada's transactions market in 2015, especially when viewed against the sector's dominance between 2011 and 2013.

On the other hand, the pricing disconnect has provided an opportunity for some REITs to acquire others, with several large M&A transactions taking place during 2015. So long as capital markets remain stable, conditions could remain ripe for more of these types of transactions this year. Such an outlook should not be seen as a stretch. That's because M&A activity has been a fairly consistent feature of the Canadian REIT sector for the past several years, averaging three takeovers a year for the last 15 years. (This track record might simply call into question whether Canada really needs as large a listed property sector to begin with.)

Market conditions also make the listed property sector ripe for potential privatizations in 2016. As we noted earlier, many pension funds remain under-allocated to real estate and the relatively tight transaction market has constrained the ability of some of these investors to meet their targets. With Canadian REITs broadly trading at discounts and pension funds underweight to real estate, privatizing a REIT with a portfolio of high quality assets could be viewed as a strategic way for these institutional investors to grow their allocations quickly. Of course, any large scale M&A and privatization activity could also help to boost average total returns for REITs and REOCs, resulting in a continuation of the significant volatility depicted by the sector in Fig. 3.1. •

Park of Commerce, Ottawa, ON
(owner: bcIMC)

Space Market Trends 4

1600 René-Lévesque Blvd W, Montreal, Quebec
(Owner: Prime Canadian Property Fund)

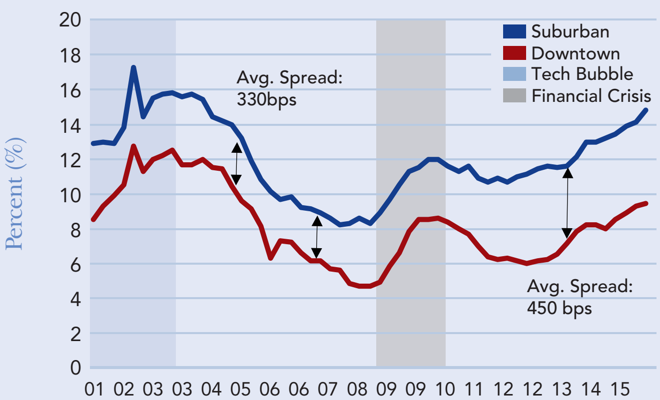
Office

Fig. 4.1.1
Quarterly Office Job Growth in Canada*

*Includes FIRE; Tech & Business Services

Source: Statistics Canada

Fig. 4.1.2
Office Vacancy Rate By Location

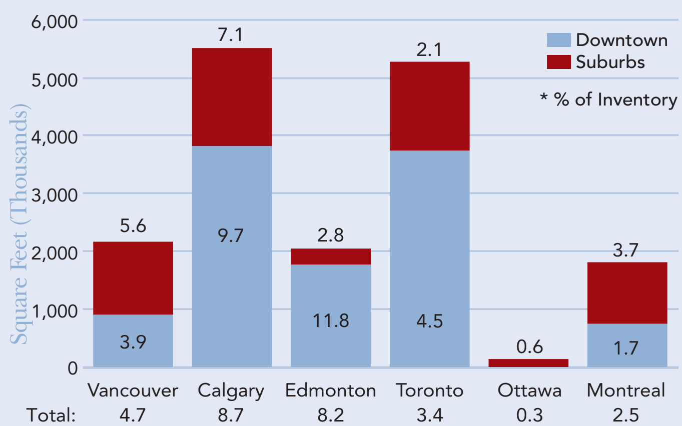


Source: CBRE, Bentall Kennedy

Canadian demand fundamentals for office continue to be relatively modest. The trend rate of office job growth (a key driver of organic office absorption) remained in the 1-2% range in 2015, below the 3-4% average growth rates experienced prior to the recession – see Fig. 4.1.1. As discussed in last year's Perspective, office tenants also remain cost-conscious such that they have continued to focus on improving the efficiency of space utilization. This has generally resulted in a decline in average space per worker over the past few years. However, these broad trends mask some underlying variation. For example, technology sector jobs have been growing at a much faster clip of about 3-5% over the past two years. In contrast, job growth in the important financial services sector (a major contributor to growth coming out of the Financial Crisis) has turned quite sluggish given general concerns about future profitability. This is largely related to the commodity price rout and the growing risk of a housing bubble and its potential impact on bank lending. It's also related to the emerging threat of financial technology or "fintech" and the competitive impact it has on the chartered banks' dominance in lending and transactions activity in Canada.

Due largely to the soft demand picture, vacancy rates in both suburban and downtown office markets have continued to move higher in tandem – see Fig. 4.1.2. However, a notable distinction in this cycle has been the persistence of a wider regional vacancy spread. For example, prior to the Financial Crisis, suburban vacancy rates averaged about 330bps higher than downtown vacancy rates. Following the Financial Crisis, the spread increased to about 450bps and has remained there since. As we highlighted in last year's Perspective, a wider spread has emerged partly because businesses have generally shown a preference to locate in densely populated downtown areas with proximity to major transportation hubs, making it easier for their employees to get to work and in the process, allowing for easier centralization

Fig. 4.1.3
Office Under Construction - Q3 2015



Source: CBRE, Bentall Kennedy

of their operations. This secular "urbanization" trend has also increased demand for large mixed use downtown properties around key transit nodes. As infrastructure is improved around urban transit nodes to allow people to live, work and play more easily, we have observed these urban buildings garner a significant value premium.

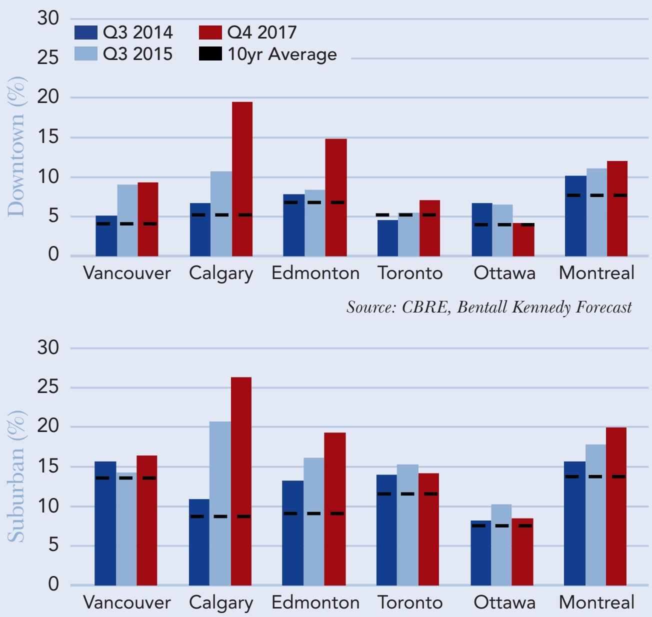
But while these trends have broadly supported downtown office properties so far in this cycle, some suburban office properties with similar "urban" characteristics such as proximity and access to major transportation nodes (both transit and highway) are also experiencing comparatively healthy demand from tenants. This partly reflects the fact that certain Canadian suburban markets such as Mississauga and Burnaby are actually major urban areas unto themselves with growing and dense populations, educated labour forces and well-developed industry clusters. Together with competitive costs, these "urban-suburban" markets remain compelling locations for many businesses. In addition to these structural factors, the rotation of Canada's growth drivers noted in Chapter 2, suggests that some traditional suburban office sectors such as U.S. branch offices, pharmaceuticals, call centres and tech manufacturing/R&D could see a material pick-up in demand going forward. For this reason, the vacancy spread between downtown and suburban office vacancy could move back to its historically tighter range as this cycle evolves.[1]

Another factor contributing to a potential narrowing of the urban/suburban vacancy spread is the new office supply pipeline. As Fig. 4.1.3 suggests, downtown office markets will generally be the biggest recipients of new supply (both directly and as a percentage of relative market size) in this cycle. In fact, the amount of downtown office space under construction across Canada, has not been this high since the late 1980's. Most of the new downtown office space is being developed by conservative institutions who have pre-leased to tenants specifically desiring modern and functionally efficient properties. As the accompanying info-box notes, strong demand for "sustainable" office buildings, whether new or refurbished, ultimately carries a significant performance premium in today's environment. But most of the tenants moving into the new buildings are also currently occupying older existing towers and many are taking advantage of the opportunity to downsize their footprint as they re-locate. Given the sluggish pace of backfilling the older stock in conjunction with the new space coming to market, we estimate that the resulting increase in overall downtown vacancy rates will be proportionately larger than the expected increase for its suburban counterpart over the next few years.

[1] Vancouver's office market has already seen this dynamic play out. The arrival of 1.3 million sq. ft. of new space in 2015 contributed to downtown Class A office vacancy increasing to 10% from less than 2% just three years earlier. In conjunction with a pick-up in suburban office leasing over the past two years, the downtown/suburban vacancy spread in Vancouver compressed to just 280bps at the end of 2015 from a peak of well over 1500bps in 2010.

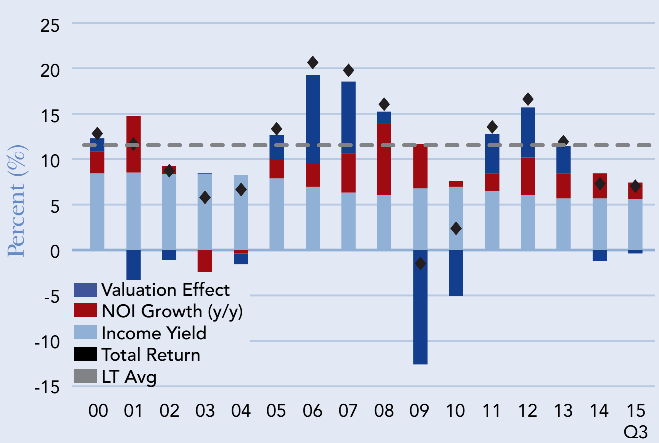
Office

Fig. 4.1.4
Vacancy Trend - Class A Office



Source: CBRE, Bentall Kennedy Forecast

Fig. 4.1.5
Decomposition of IPD Office Returns



**12 Months Ending In Q3 Of Every Year*

Source: IPD Canada; Bentall Kennedy

Regionally, the most notable casualty of rising office vacancy in Canada during 2015 has been Calgary. This has mainly been a demand side story given that 80% of this city's tenant base is linked to the beleaguered energy sector. With demand conditions expected to remain weak and new supply (equating to almost 10% of the existing inventory) exacerbating the situation, Class A office vacancy in downtown Calgary is likely to continue moving higher and could easily breach 20% by 2017. As Figures 4.1.4 shows, average Class A office vacancy rates in most other regions, especially in the West, are also likely to continue moving (or remain) above their long term averages over this year and next. For a detailed discussion of specific regional office market trends please see Chapter 5.

Rising vacancy, particularly in older, less well-located buildings is driving quoted office rental rates lower in many Canadian markets. Not surprisingly, the biggest deterioration has been in downtown Calgary where rents have contracted by 30% from a year earlier. Meanwhile, operating costs have marginally increased in some major markets, reflecting the higher capital expenditures incurred by landlords attempting to keep their existing inventory competitive in the face of new supply. The main implication of these trends for investors is that office NOI growth, which according to the IPD increased by 1.8% in Q3 2015, is likely to be more modest over the medium term with a growing possibility of even a contraction. With record low going-in yields (see Fig. 4.1.6) and the potential for cap rates to decompress (especially in the oil-ravaged markets of Alberta), overall returns in the cyclical office sector could remain well below its long term average for at least the next two years.

SUSTAINABLE OFFICE BUILDINGS OUTPERFORM

According to a ground breaking study commissioned by Bentall Kennedy, there is compelling evidence that buildings with sustainable certification outperform similar non-green buildings in terms of rental rates, occupancy levels, tenant satisfaction scores, and the probability of lease renewals. The study of nearly 300 office properties across North America included lease-level data such as rents, rent concessions and lease renewal rates, as well as building-level information such as occupancy rates, tenant satisfaction scores, energy and water consumption, and green building certifications.

This study is an important step toward mapping the business case for sustainable building attributes.

To read the complete study, please click **here**.

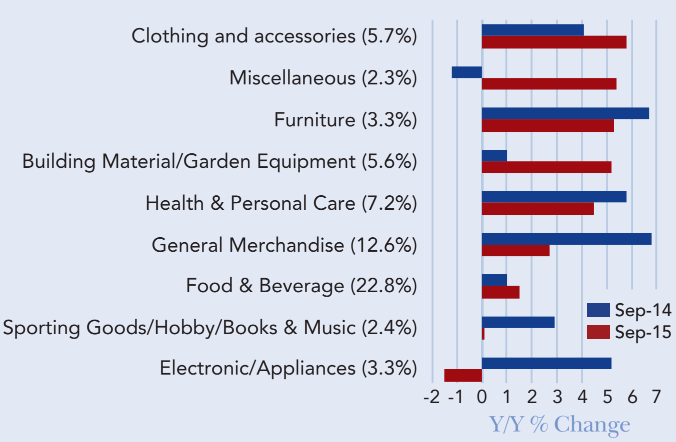
Retail

Fig. 4.2.1
Core* Retail Sales

*Excludes auto and gas sales

Source: Statistics Canada

Fig. 4.2.2
Retail Sales by Store Type



*Brackets are share of total retail sales

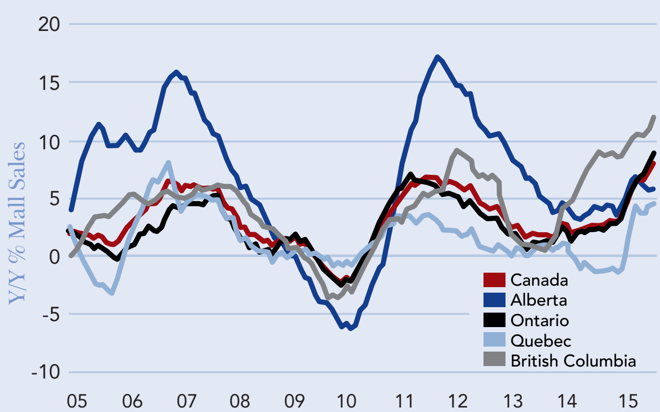
Source: Statistics Canaa

Canadian core retail sales (which excludes gasoline and automobile purchases) materially improved in 2015 as trend growth rates moved back into the 3-4% range from the 1-2% levels seen over the previous two years – see Fig. 4.2.1. In the absence of any meaningful gains in household incomes, part of the increase was driven by the sharp drop in gasoline prices, which left more money in the wallets of consumers for discretionary spending. But an even more powerful source of support for Canadian consumers was a reduction in interest rates. As noted in Chapter 2, this helped to keep debt servicing costs low and continued to spur strong housing demand, especially in the affordability-constrained markets of Toronto and Vancouver. The on-going strength of housing had a positive spillover effect on housing-related spending with furniture retailers continuing to lead sales over the past two years – see Fig. 4.2.2. Sales have also been solid at clothing and accessories stores as well as building materials and health & personal care stores during 2015.

Bricks and mortar retail has broadly benefited from these improvements in consumer spending. For example, mall sales productivity – a key indicator of retail property performance – reached an annualized $721 psf in October 2015 surpassing the $700 mark for a fourth consecutive month. (Sales psf has never exceeded $700 psf in Canada prior to 2015). As Fig. 4.2.3 shows, mall sales growth was strongest in British Columbia and Ontario and even held up in Alberta, despite the hit that consumers in that province have taken from the meltdown in oil prices.

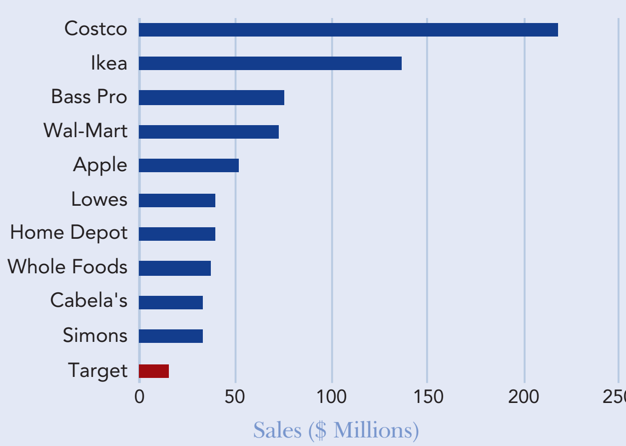
While this paints a generally positive picture of retail conditions during 2015, Canadian landlords and investors are quite cautious about the prospects for

Fig. 4.2.3
Mall Sales Growth



Source: ICSC

Fig. 4.2.4
Target vs. Top Retailers in Canada By Sales Per Store



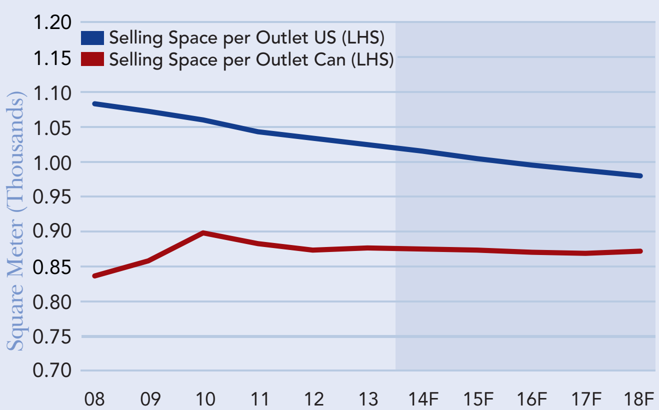
Source: CSCA

retail given a number of developing headwinds in this property market. On a macroeconomic level, bloated debt levels, slow job growth and constrained housing affordability in some regions suggest that Canadian consumers have little capacity to continue spending at 3+% rates going forward – see Chapter 2. This is especially true in Alberta, where the lagged effect of job losses, high debt levels and declining incomes due to the oil price correction is likely to result in significantly weaker retail activity this year.

From an operating standpoint, many landlords are also coping with the demise of a number of retailers in Canada. As we noted in last year's Perspective, this list has included several familiar brands that have fallen victim to an increasingly competitive retail landscape. The most high-profile (and arguably material) retail departure in 2015 was Target. Although expectations were high for Target when it began operations in Canada in 2013, the retailer was marred by inventory problems as well as uncompetitive pricing. With its sales lagging far behind big box rivals such as Walmart– see Fig.4.2.4 – Target abruptly decided to exit the country altogether in early 2015 and permanently close all of its 133 stores. Although Target provided varying settlements to its landlords, the exit of this retailer (together with others) resulted in an estimated 21 million square feet of total retail space returning to the market in 2015. For context, this is almost three times the amount of new retail development that occurs annually in Canada. Fortunately, Canada does not have an oversupply of retail properties (and so-called 'dead malls') like the U.S. does. So the space returned to the market has not resulted in the double-digit vacancies and distress that was seen in the U.S. retail sector following the Financial Crisis in 2008.

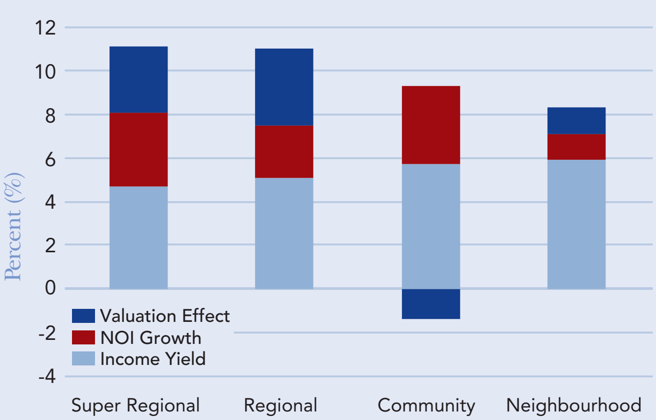
Retail

Fig. 4.2.5
Non Grocery Retail Selling Space Per Outlet



Source: Euromonitor International; Bentall Kennedy

Fig. 4.2.6
Decomposition of 3 Year Returns By Property Type



**As of Q3 2015*

Source: IPD Canada

For operators of the country's best retail malls, most were happy to have the leases of Target (and others) returned to them as they viewed it as an opportunity to attract other, stronger retailers at better rents. Many of these retailers continue to be foreign with strong international brand recognition and a strategic desire to expand and position themselves in the best retail locations in Canada. Some Target leases were also bought by a number of rivals, including Walmart and Canadian Tire, who are intent on making their already dominant positions in the Canadian market, even stronger.

But in most other cases, the Target stores have generally been too big for any one retailer, which is forcing a number of landlords to divvy up space among multiple retailers – a costly endeavor. This is an especially tough situation today given that many retailers are also re-thinking how much bricks and mortar space they require now that much of their incremental growth is being derived on-line. Outside of certain iconic fashion brands, many retailers across North America have therefore compressed the size of their formats, resulting in flat to declining average retail selling space per outlet – see Fig. 4.2.5. At the same time, rising costs (due to the higher C$ and shrinking profit margins) are causing many retailers to also push hard against higher rents.

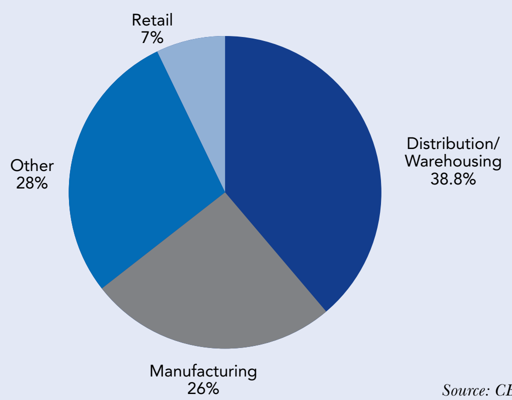
The major investment implication of these trends is a continued bifurcation of retail property performance. On the one hand, super and other "higher tier" regional malls continue to see very low vacancy and strong sales growth as these properties continue to attract both shoppers and new retailers. This has translated into strong capital appreciation over the past three years thanks to both healthy NOI growth and significant cap rate compression – see Fig. 4.2.6. Landlords of these retail centres have also engaged in major capital improvement programs over the past few years, not just to keep their centres vibrant and "experiential" but to simply accommodate new retailers eager to locate in their malls. Similar strength has been seen at new format "premium outlet" centres, where the allure of big name brands at discounted prices is making solid inroads with Canadian shoppers.

On the other hand, community malls and neighbourhood/power centres located predominantly in fringe areas, are struggling with tenant departures and weak foot traffic. This has translated into comparatively lower total returns over the past three years, entirely due to lackluster capital appreciation – see Fig. 4.2.6. In the current environment, owners of these centres have been forced to aggressively "re-invent" their properties to keep them relevant. This sometimes means engaging in significant capital improvements to re-configure the property or re-orienting tenancy towards more services (such as food offerings, medical clinics and fitness centres) since these groups provide social experiences and services that cannot be purchased remotely. In other more extreme cases, the footprint of some shopping centres may have to be reduced or ultimately removed altogether, as they are transformed into other more productive uses such as residential.

Brantford Commons, Brantford ON
(owner: Prime Canadian Property Fund)

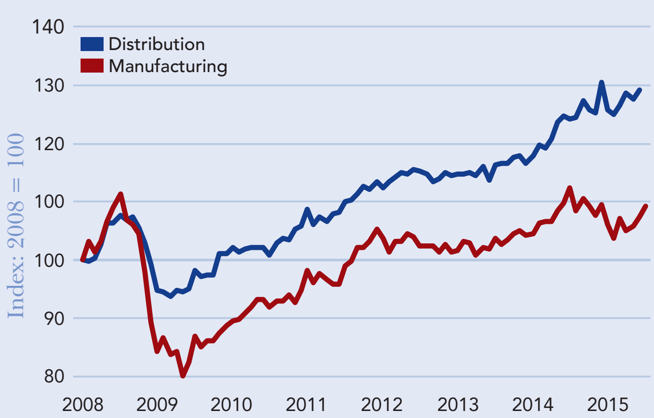
Industrial

Fig. 4.3.1
Distribution of Industrial Leases in 2015 By Sector



Source: CBRE

Fig. 4.3.2
Manufacturing & Distribution Activity

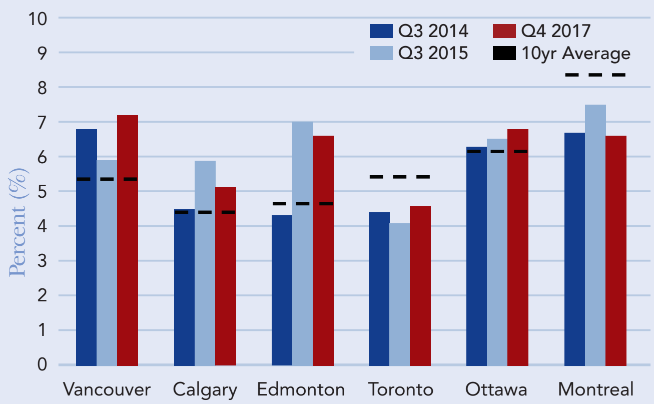


Source: Statistics Canada

As noted in Fig. 4.3.1, distribution and warehousing tenants led lease deals in Canada's industrial property market in 2015. Demand conditions in this key sector have been quite robust, particularly over the past two years with distribution activity increasing by more than 10% (See Fig. 4.3.2). Part of this growth has been cyclical as the economy recovered from the Financial Crisis. But as we discussed in detail in last year's Perspective, a key element of this growth has been structural. For example, the increasing integration of North American business and consumer good supply chains to improve efficiency combined with the growth of e-commerce and the growing need of suppliers to fulfill online customer orders quickly, has given rise to the importance of third party logistics (3PLs) operators in the distribution process. These users generally require modern, large bay industrial properties with high clear heights located close to major population centres and key transportation networks. Although a materially lower Canadian dollar is likely to put some pressure on the logistics and distribution sector going forward (since it will generally squeeze the margins of this import-dependent sector), distribution activity should remain near current robust levels as on-line shopping continues to gather momentum while companies continue to seek out operational efficiencies within their supply chains.

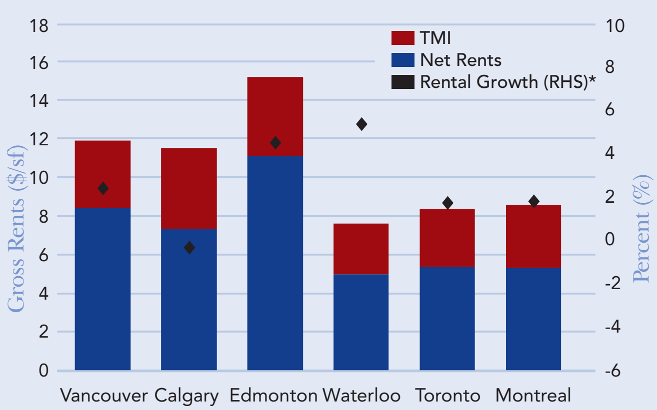
Manufacturing is the next largest industrial user group, accounting for over a quarter of Canadian industrial leases signed in 2015. Although manufacturing's relative share of the industrial market is down materially from a decade ago when it had a much larger footprint in the economy, Fig. 4.3.1 confirms that it is still an important tenant group. To be sure, the sector's presence is not just in the manufacturing-heartland of Central Canada, but is also found in key Western markets such as Edmonton where pipe-fitting, petroleum and petrochemical manufacturing are important industrial tenant groups. While this reflects the significant diversity of what manufacturers do "inside the box," the sector has collectively not felt the full benefits of a lower

Fig. 4.3.3
Regional Industrial Availability Trend



Source: CBRE, Bentall Kennedy

Fig. 4.3.4
Industrial Rents



** 5 Yr Annualized Growth*

Source: CBRE

exchange rate because of various hedges. As these positions unwind, Canadian manufacturing activity should see a material pick-up in growth, especially since demand from its major export market – the U.S. – has also improved considerably.

While stronger manufacturing activity should be a tailwind for the industrial market over the coming year, it is important to note that it may not have a significant impact on overall industrial market statistics. This is because manufacturing's general reliance on small bay properties leaves a smaller footprint on average availability rates compared to the distribution sector, which typically drives occupancy in large bay/higher square footage properties. In fact, strong distribution demand for big box space is the major reason why industrial availability has been relatively tight in much of the country, especially Toronto (see Fig. 4.3.3). Even Calgary's industrial market has not been impacted to the same degree as its office market from the oil price rout because the city is a key distribution hub for Western Canada. As a result, steady demand for big bay space by logistics groups has kept industrial availability rates in the mid-single digits. In contrast, Edmonton's industrial market, which as noted above is more closely tied to the oil sector via petroleum manufacturing, has seen a material increase in industrial availability in 2015. For more on regional industrial conditions, see Chapter 5.

Tight industrial markets have given way to higher industrial lease rates in many parts of the country (see Fig. 4.3.4) and particularly in Central Canada over the past year.[2] These improvements stand in sharp contrast to the office sector, where quoted rental rates in most markets are trending lower as the sector struggles to absorb new supply, both recently delivered and still in the pipeline.

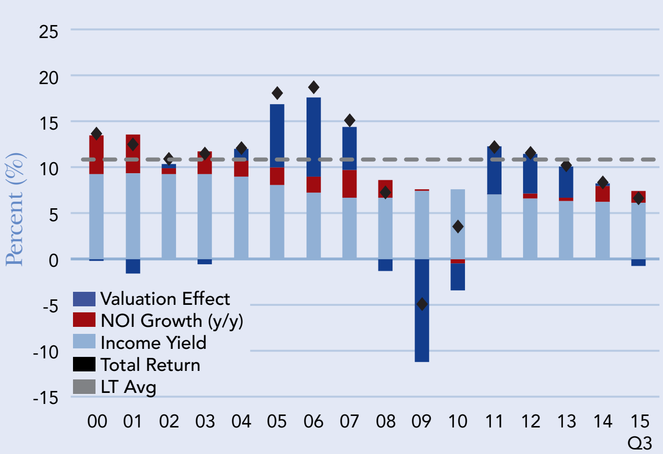
[2] A sharp fall in average industrial rents was recorded in Calgary in 2015, but this was mainly concentrated in small bay properties catering to energy sector tenants. In contrast, average rents and availability for large bay properties in this city have remained generally stable. For more detail on regional conditions, see Chapter 5.

Industrial

Fig. 4.3.5
Industrial Under Construction

Source: CBRE

Fig. 4.3.6
Decomposition of Industrial Returns



**12 Months Ending In Q3 Of Every Year*
Source: IPD Canada; Bentall Kennedy

To be sure, rising rents and strong demand have also kicked-off a robust development cycle in the industrial market. As of Q3 2015, there was over 22 million sq. ft. of new industrial space under construction in Canada, the most on record. However, Fig.4.3.5 shows that this equates to only 1.3% of inventory, much less than the relative development occurring in the office sector. Moreover, much of this new space is "built-to-suit," such that it is does not have the propensity to severely distort the overall supply and demand balance.

In terms of product type, large bay structures represent the majority of construction underway, with the average size of new buildings continuing to increase based on the demand preferences of prospective tenants. For example, the average size of a new industrial building as of Q3 2015 was 141,000 sq. ft., up from 84,000 sq. ft. just eight years earlier. As noted above, much of the demand for large bay facilities is occurring in the key distribution markets of Toronto and Calgary where the average size of a new builds is considerably higher than the Canadian average. The GTA average for new builds is 270,000 sq. ft. while Calgary's average is 195,000 sq. ft.

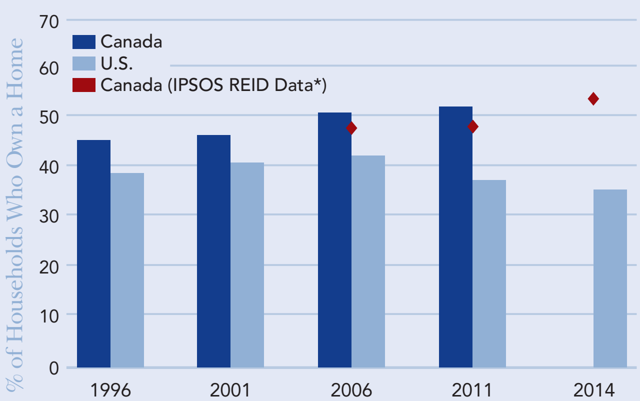
In contrast, there has been a relative absence of new small bay product being brought to the market given the higher creation costs for this type of building. With the likelihood of increasing demand for this product as manufacturing activity gains traction, this segment of the industrial market could see significantly lower availability and stronger rental growth over the next year.

For investors, higher overall rents have had a positive impact on industrial NOI growth. According to the IPD Canada index, industrial NOIs increased by only 1.3% y/y as of Q3 2015 – see Fig. 4.3.6. Although this figure seems to be quite low (and may be attributed to the relative mix of industrial properties found within the IPD index) we believe NOIs for high-quality industrial buildings are likely to remain on track for continued moderate growth thanks to the relatively healthy space market fundamentals noted above. In conjunction with comparatively higher yields than other property types, the continuation of moderate NOI growth should position industrial as one of the better performing property types in Canada this year.

500 Pinebush Road, Cambridge, ON
(owner: Prime Canadian Property Fund)

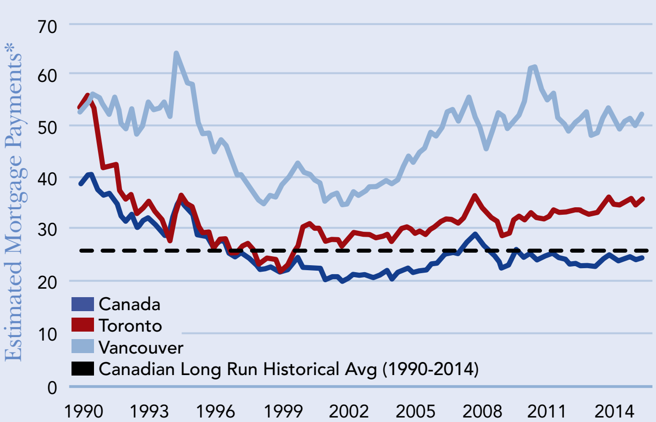
Multi-residential

Fig. 4.4.1
Home Ownership Rates - Under 35 Years Old



Source: TD Economics
* Statistics Canada National Household Survey only provides homeownership ratesup to 2011
TD uses the IPSOS REID Survey to get a more recent update on homeownership rates

Fig. 4.4.2
Housing Affordability



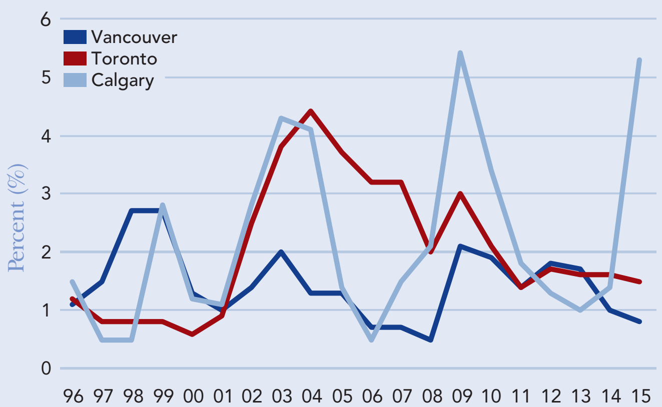
*On an average price house as a % of average household income. Assuming average home price, 25% downpayment, 25 year amortization

Source: CREA, Statistics Canada

As we discussed in last year's Perspective, Canada remains a nation of homeowners. While overall U.S. homeownership rates have remained subdued following the implosion of that country's housing bubble, Canadian homeownership rates have shown no sign of turning lower. The propensity to own rather than rent is not limited to older age groups in Canada, but is also evident for the much-discussed Millennial demographic (those between the ages of 20 and 35). As Fig. 4.4.1 shows, more than half of all Canadian Millennials owned homes in 2014 compared to less than 40% in the U.S., with the trend for Canadians in this age group also moving successively higher over the past 20 years. Although young Canadians and Americans share many similarities, a key reason for this particular difference is that Canada has not recently suffered a housing crash as home prices have continued to steadily appreciate. So unlike their American counterparts, young Canadians continue to view housing as a safe and solid investment and renting as a "dirty word". In addition, Canadian Millennials tend to have a stronger attachment to the labour force than American Millennials, as well as higher income levels and greater net worth. These economic differences have simply resulted in a greater capacity for young people in Canada to purchase homes. Lastly and from a structural standpoint, the ethnic make-up of Canadian Millennials includes a greater share of groups that place a high cultural importance on home ownership. The main implication property investors should draw from these demographic differences is that potential rental demand in Canada simply does not have the same tailwinds behind it as the U.S.

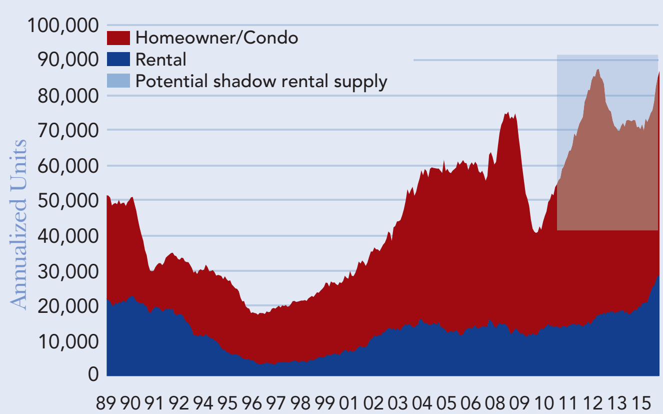
That said, Fig. 4.4.2 shows that housing affordability has become quite stretched in Vancouver and Toronto compared with the rest of the country, even at record low mortgage rates. The major reason has to do with sharply rising home prices and flat

Fig. 4.4.3
Rental Vacancy Rates*



* *Apartment structures of six units and over* *Source: CMHC*

Fig. 4.4.4
Annual Apartment Housing Starts By Tenure



* *Apartment structures of six units and over* *Source: CMHC*

income growth in both markets – see Chapter 2. This is forcing some households with little to no equity in Toronto and Vancouver to increasingly delay entry into the housing market, and combined with healthy population growth, has contributed to even tighter purpose built apartment vacancy rates in both cities – see Fig. 4.4.3. This situation stands in sharp contrast to trends in the rest of the country as apartment vacancy has generally increased in most other regions over the past year. This is especially true in the oil-ravaged markets of Calgary and Edmonton where rising unemployment and falling incomes are leading to an outflow of people to other provinces and consequently, a sharp decline in potential rental demand.

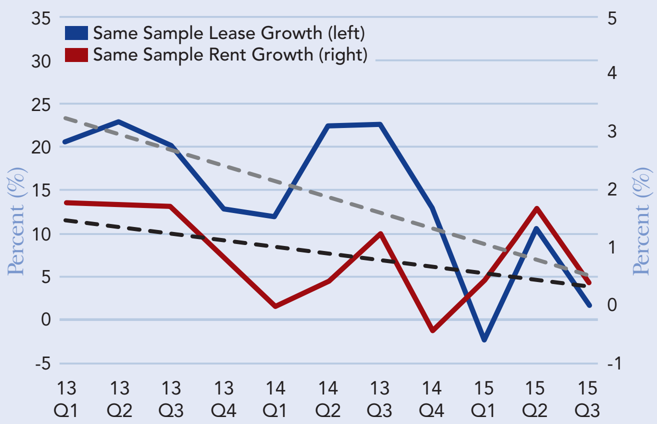
The generally tight rental market conditions in Toronto and Vancouver (as well as the also previously tight Calgary market) have contributed to a material increase in new apartment construction with purpose-built rental starts now at their highest level since the early 1990s – see Fig. 4.4.4. Since much of the existing stock of apartment rentals is old, tired and in some cases, suffering from outdated layouts and a lack of amenities, these new developments should fill a void in the marketplace for functionally modern product. Indeed, many of these new apartments directly address the growing desire to simultaneously "live, work and play" since they are part of larger mixed-use developments in densely populated areas alongside key transit nodes. However, there is no shortage of similar "shadow rental" units available in the new condo market (see Fig. 4.4.4), particularly in Toronto. As noted in previous Perspectives, condo construction is running at record high levels in Canada with more than half of these new units ultimately purchased and leased by small private investors.

It is not clear from available statistics how these condo "shadow rentals" impact overall apartment

Multi-residential

Fig. 4.4.5

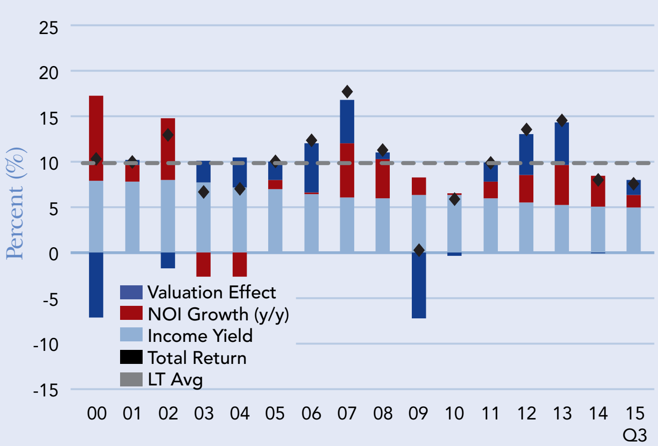
Average Growth in Same Sample Condo Leases and Rents in the GTA



Source: Urbanation, TREB

Fig. 4.4.6

Decomposition of Multi-Residential Returns



**12 Months Ending In Q3 Of Every Year*   *Source: IPD Canada; Bentall Kennedy*

market conditions. We generally believe that rented condos cannot fully compete with new purpose built apartment rentals because potential renters prefer to have an institutional property manager over an "absent landlord" and will pay a premium to have one. However, others suggest that most potential renters are indifferent about property management and when faced with the choice of similar units, will always opt for the least costly because renters tend to be a very cost-cautious group. This would suggest that the market for multi-residential product may not be as bifurcated as the former suggests.

This distinction is important because it has implications for the direction of overall rents in the multifamily market. For example, Urbanation has found that the saturation of new condo units for rent in Toronto, has largely contributed to a downward trend in "same store" rent growth in this sector – see Fig. 4.4.5. Considering the forthcoming surge of completions in both condos and purpose built rental units in the face of generally moderate demand, it is possible that overall multifamily rents could see broad downward pressure over the next few years. However, we believe that well located, modern apartments with plenty of amenities, as well as an institutional landlord, should be relatively immune to this broad market pressure.

As we noted in Chapter 3, the limited prospects for cap rate compression puts the onus on NOI growth to support prospective returns in the current environment. In this regard, Fig. 4.4.6 shows that there has been generally healthy NOI growth in multi-residential over the past few years helping to make the sector one of the top overall performers among property types in recent years. But as we discussed above, the propensity for continued multi-residential rent growth over the next few years appears to be constrained largely by a glut of potential new supply. NOI growth in Alberta's multi-residential will also be weighed down by weaker rental demand and rising vacancy due to the deterioration of its economy and weaker population growth. However, multi-residential remains a preferred property type, not only by equity investors, but also lenders (see Chapter 4). Despite low going-in yield, robust demand and good access to inexpensive CMHC-insured debt could continue to drive strong capital flows into this sector and support further valuation gains, especially in Toronto and Vancouver. As a result, multi-residential could still remain one of the best performing property types in the near term despite softening prospects for NOI growth in the broader market. •

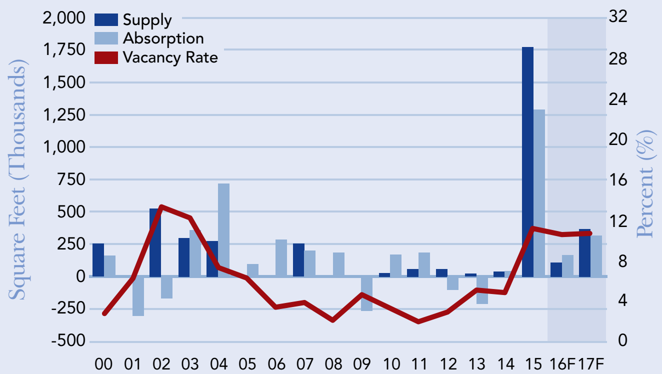
Nevada Place Apartments, St. Albert, AB
(Owner: Prime Canadian Property Fund)

200 King Street W, Toronto, ON
(owner: bcIMC)

5 Regional Overview

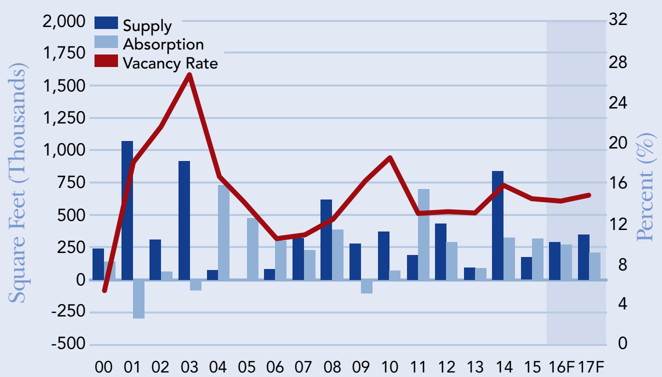
Vancouver

Class 'A' Office Fundamentals *Downtown*



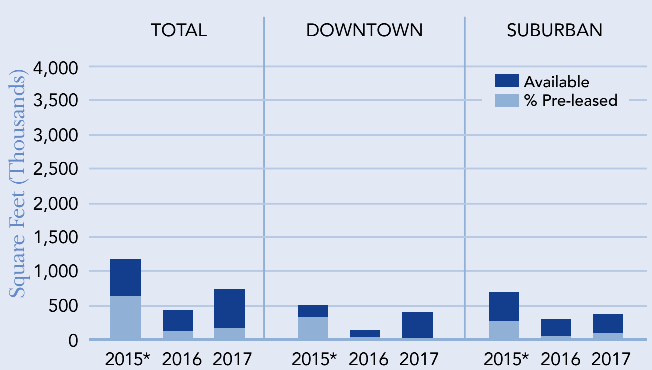
Source: CBRE, Bentall Kennedy

Class 'A' Office Fundamentals *Suburban*



Source: CBRE, Bentall Kennedy

Class 'A' Office Under Construction *by Completion Date*



**Completions For 2015 Q4*

Source: CBRE

Economic Drivers

Economic activity in the Metro Vancouver area is expected to gain further traction in 2016 with real GDP growth the highest among major cities. Stronger U.S. demand and a lower Canadian dollar should allow exports to be a key economic driver. Manufacturing output is poised to benefit from these favourable conditions and this sector is expected to provide most of the heavy lifting for the regional economy going forward. As a key port and distribution hub, these economic drivers should also support Vancouver's logistics and transportation sector. The tech sector is another bright spot for Vancouver's economy, driving healthy employment and wage growth for the region. This should continue to support retail activity, which should also get an additional lift from heightened tourism spending owing to the weaker loonie.

Several risks are still present for the Metro Vancouver economy. As key Asian markets continue to grapple with sluggish growth, the demand for commodities will remain soft. This is likely to weigh on investment activity within the resources sector. Elevated debt levels associated with an overvalued housing market could also potentially curtail consumer spending and overall domestic demand in the Metro Vancouver area, especially when interest rates eventually rise from their current lows.

Office Market

Downtown class A office vacancy in Vancouver rose substantially in 2015. Although, muted leasing activity from weak organic office demand was partly responsible, much of the upward pressure has been supply-induced. Many traditional downtown tenants have been awaiting the new supply and the majority of it has been pre-leased. However, backfilling the vacated space has been soft. Excess supply (both from new inventory and backfill space) could lead some landlords to focus on inducements rather than push for rental growth. This may result in some downward pressure on overall downtown office rents over the next two years.

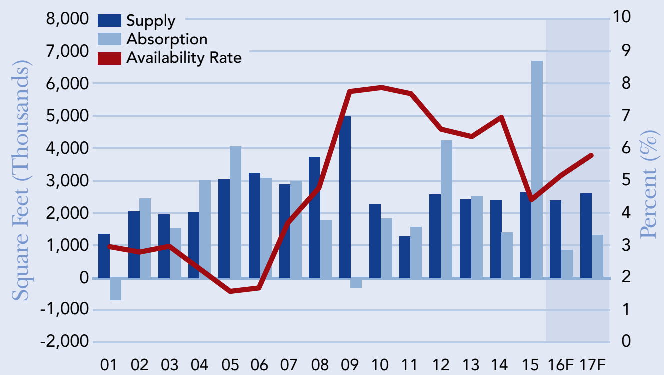
Meanwhile, the Vancouver suburban office market has seen steady leasing activity over the past year. In search of more affordable space options, some traditional downtown tenants have been relocating to the suburbs. Suburban office demand has been particularly strong along transit, where some tenants are taking advantage of greater leasing options at affordable rents, while maintaining transit access for their workforce. These improved conditions have resulted in a decline in suburban class A vacancy over the past year.

Looking ahead, with the increase in leasing options and a potential downward adjustment in rents within the downtown market, tenant demand, particularly from Vancouver's growing tech sector, may return more forcefully to the downtown region. This is especially true given that tech tenants often want to attract young educated workers who tend to reside in the core. This implies that leasing activity may soften to some extent in the suburban office market.

Industrial Market

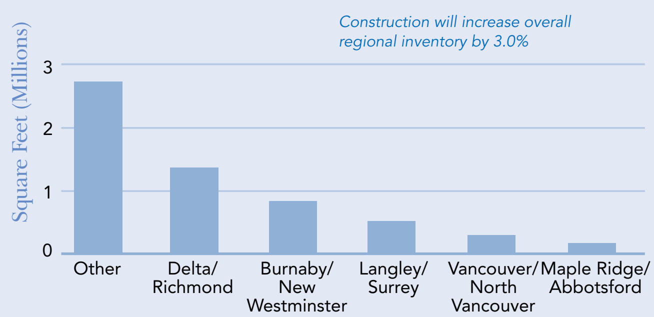
Vancouver's industrial market has been one of the strongest in the country accounting for 40-50 percent of national leasing activity in 2015. As a port city and a distribution hub for Western Canada, healthy retail spending and the increased need for suppliers to get their goods to customers efficiently have been key drivers for the demand of industrial space, especially large bay and distribution-oriented product. Developers have responded relatively quickly to this need for newer generation industrial space with 4.7 million sf of new space under construction at the end of 2015. With the supply of developable land dwindling, development costs (due mostly to higher land value) remain on the rise. With solid industrial demand in recent years, landlords have been well positioned to pass these higher costs on to tenants. As a result, asking lease rates have seen decent growth and are currently among the priciest in the country at around $8.30 – $8.50 psf.

Industrial Fundamentals



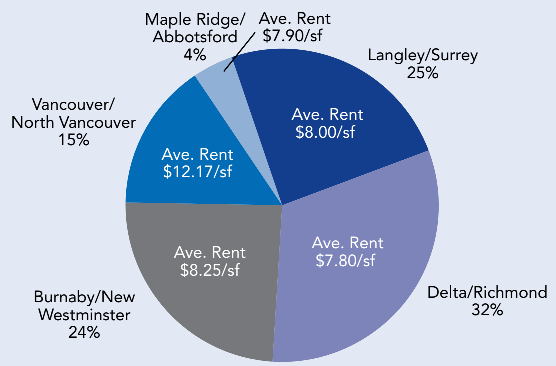
Source: CBRE, Bentall Kennedy, CBRE-EA

Industrial Under Construction *by Sub-Region*



Source: CBRE
**From 2015 Q4*

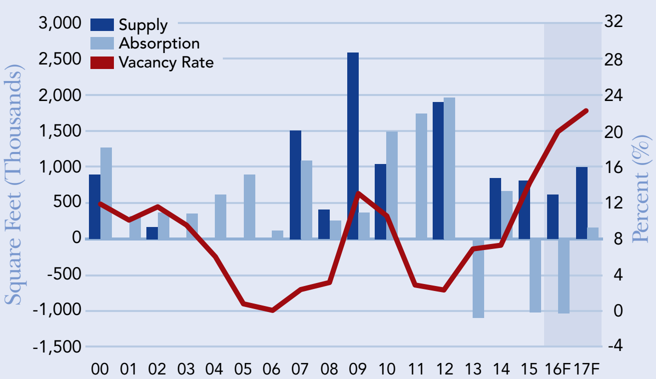
Industrial Breakdown *by Region, Total Inventory 182M SF*



Source: CBRE, Bentall Kennedy

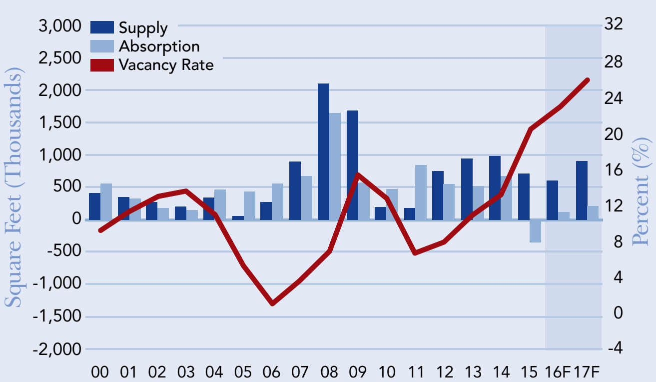
Calgary

Class 'A' Office Fundamentals *Downtown*



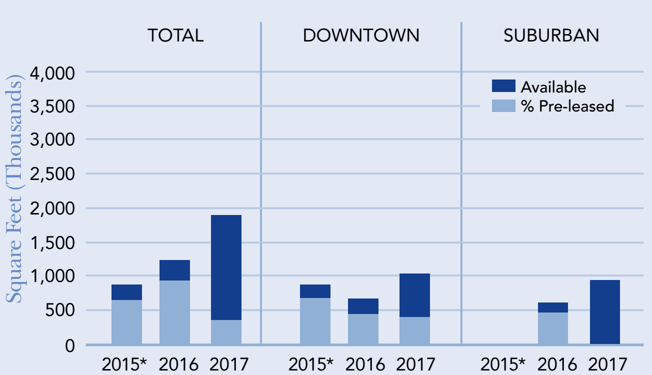
Source: CBRE, Bentall Kennedy

Class 'A' Office Fundamentals *Suburban*



Source: CBRE, Bentall Kennedy

Class 'A' Office Under Construction *by Completion Date*



**Completions For 2015 Q4*

Source: CBRE

Economic Drivers

The Calgary economy has been crippled by the plunge in oil prices and a recovery to profitable levels for Alberta energy producers (who are mainly headquartered in this city) is not expected anytime soon. As many energy firms continue to endure record losses and value write-downs on their oil reserves, investment activity within the oil patch should remain muted along with the further downsizing of the labour force. The rejection of the Keystone pipeline poses another challenge for the energy sector as it will constrain the ability of Alberta oilsands producers to distribute existing oil production in a cost effective manner.

As long as oil prices remain at unprofitable levels for new investment, other parts of Calgary's economy are likely to remain under pressure as well. Although consumer confidence has been more resilient compare to the 2009 recession, retail spending in Calgary is beginning to materially slow due to weaker job and income growth. This will weigh on domestic demand in the region this year. The housing market has already adjusted to these softer economic conditions. House prices in Calgary have fallen over the past year in reaction to weaker housing demand and are likely to slip even further as people relocate to other parts of the country in search of better job opportunities.

Office Market

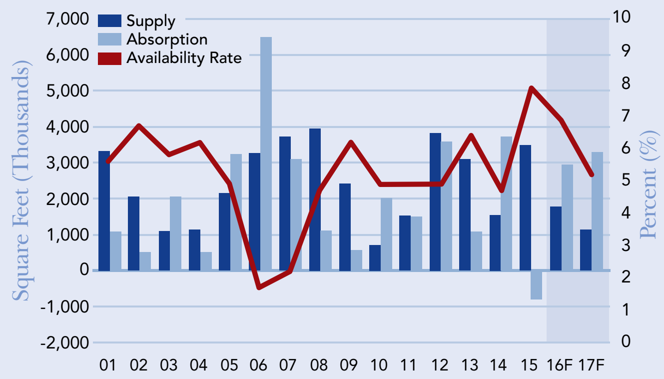
The struggling energy sector has severely impacted Calgary's office market. Downtown class A office vacancy reached a five year high of 14 percent in 2015, largely due to the shedding of space into the sublease market. With expansion plans halted in the energy patch, many firms are downsizing their space needs. As a result, sublet space as a percentage of total vacancy in downtown Calgary is at a whopping 50 percent, the highest level in the country by a wide margin. Landlords are coping with these tough conditions by discounting lease rates as overall downtown net rents have fallen by approximately 30 percent over the past year. Similar to the downtown, there has been a material rise in class A vacancy in the suburbs due to an influx of sublease space. This is most evident in the South submarket given its stronger ties to the energy sector. In contrast, with a more diversified tenant base, the Northeast and Southcentral submarkets have seen steady leasing activity and vacancy in these regions has held up relatively better.

Looking ahead, demand for office space in Calgary is likely to remain weak, especially since oil prices are unlikely to return to levels that are deemed to be profitable for many Alberta producers. On the supply side, Calgary's office market is in the midst of a very active development cycle with 4.6 million sf of new space currently under construction. The addition of this new supply amidst weak demand is expected to drive class A vacancy in both the downtown and suburbs above the 20 percent mark by the end of 2016, with average rents continuing to adjust downward over this period.

Industrial Market

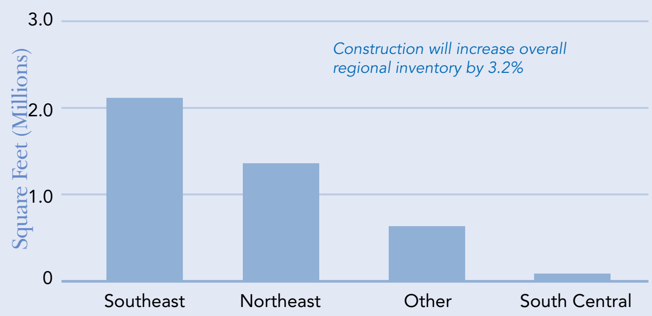
Calgary's industrial market underperformed in 2015 as availability increased to 8 percent. However, unlike its office counterpart, it has been less exposed to the plunge in oil prices. This is because only 20% of Calgary's industrial market is directly related to tenants servicing the energy sector. These energy-dependent tenants also typically occupy smaller bay product which at present, is seeing the slowest leasing velocity. Meanwhile, the majority of industrial leasing demand is from logistics-related industries that tend to operate in large bay properties. Demand has continued to remain steady in this sector since the city serves as major distribution hub for Western Canada and an intermediary supply chain link with Central Canada. With trade expected to be the main driver of national output and retailers continuing to improve their distribution capabilities, demand for large bay product should continue to garner interest from tenants and offset some of the weakness from the energy sector. In contrast, weak demand for small bay and functionally obsolete industrial space will continue to force many landlords of this product to offer discounted rates to secure tenants. This has already been a significant factor contributing to the 12 percent y/y decline in overall industrial rents in Calgary over the past year.

Industrial Fundamentals



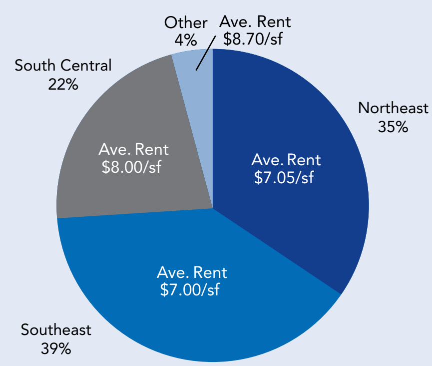
Source: CBRE, Bentall Kennedy, CBRE-EA

Industrial Under Construction *by Sub-Region*



Source: CBRE
**From 2015 Q4*

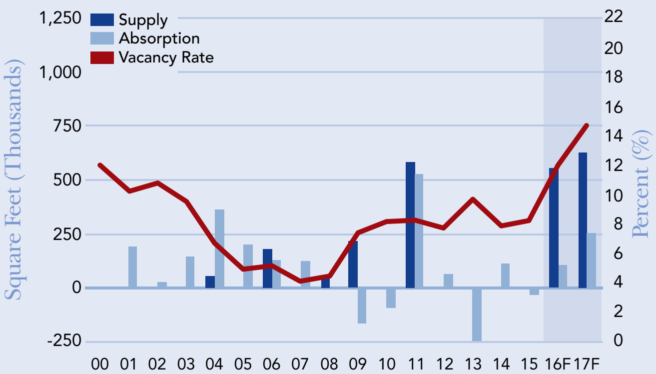
Industrial Breakdown *by Region, Total Inventory 127M SF*



Source: CBRE, Bentall Kennedy

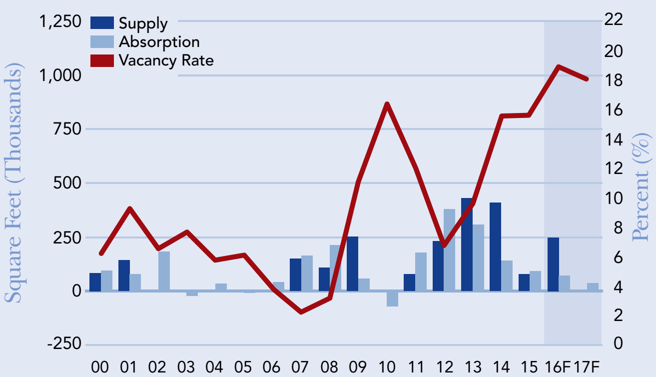
Edmonton

Class ‘A’ Office Fundamentals *Downtown*



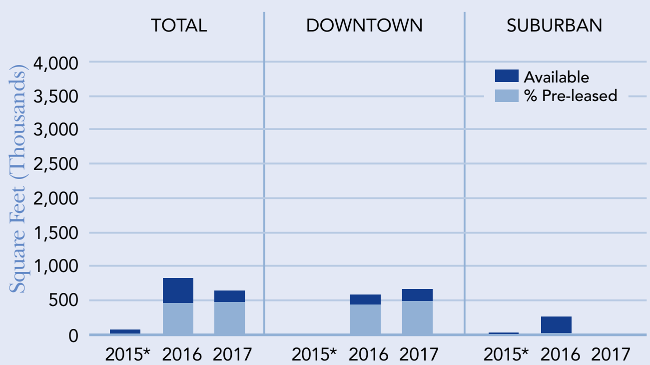
Source: CBRE, Bentall Kennedy

Class ‘A’ Office Fundamentals *Suburban*



Source: CBRE, Bentall Kennedy

Class ‘A’ Office Under Construction *by Completion Date*



**Completions For 2015 Q4*

Source: CBRE

Economic Drivers

Edmonton’s economy is highly exposed to the deteriorating conditions in the energy sector with output and job growth in the city softening substantially. Burdened by an unprofitable price point for Alberta’s crude oil, energy producers are weary and investment activity within the nearby oil sands is likely to remain muted through 2016. This will weigh on manufacturing output in Edmonton, given that it partly relies on the servicing of oil and gas extraction. The rejection of the Keystone XL pipeline is also detrimental to the long term prospects of Alberta’s energy sector, and a huge loss to Edmonton’s manufacturing sector, which was poised to benefit from the construction and servicing of this pipeline.

Economic growth should modestly improve this year. Ongoing construction of previously committed commercial projects should provide some stability to the labour market. With a new provincial government in place, the key public and administration sector should continue to provide stability for Edmonton’s economy. However, lower royalties due to declining energy production could force the provincial government to engage in cost cutting measures and raise taxes beyond 2016 if oil prices do not materially recover.

Office Market

The downtown class A office market underperformed and absorption was negative in 2015. Much of this weakness stemmed from cautiousness among tenants due to the ongoing struggles of the energy sector. The Financial node felt the brunt of these softer conditions as some private sector tenants downsized and released excess space into the sublease market. Although not to the same extent as downtown Calgary, sublease space as a percent of total vacancy in downtown Edmonton increased sharply over the past year and is currently at 32 percent. Downtown Edmonton’s other key node, the Government district, saw very little leasing activity as well, and this was partly due to the public sector remaining idle during the provincial and federal elections in 2015.

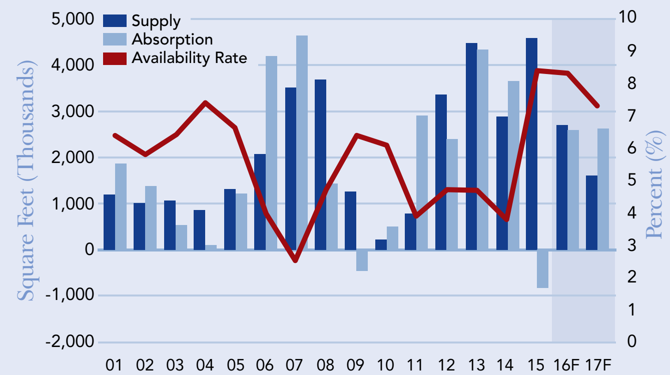
The downtown office market currently has 1.8 million sf of new supply under development, the highest volume on record. Therefore, the outlook is highly contingent on whether demand in this relatively small office market can keep up with the new supply. With more leasing options on the horizon, the city of Edmonton could further consolidate its staff from surrounding nodes into the core. Although this could generate improved leasing activity, it is unlikely to be enough to accommodate the new inventory. As such, downtown class A office vacancy is likely to experience considerable upward pressure going forward.

Despite a stronger link to the energy sector, leasing activity has been relatively stable in the suburban class A office market. This is partly due to the fact that landlords have been successful in securing tenants for high quality space with generous inducements and lower rents. However, absorption levels were not enough to outpace the steady flow of supply and as a result, suburban class vacancy has moved significantly higher. Looking ahead, depressed oil prices should continue to dampen suburban leasing activity as office using sectors such as engineering services remain cautious.

Industrial Market

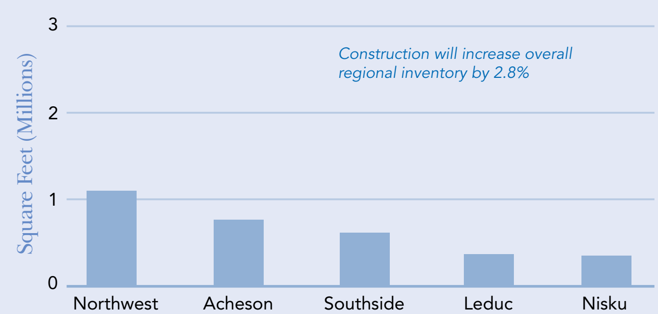
Edmonton industrial leasing activity cooled considerably in 2015 and absorption ventured into negative territory for the first time since 2009. Together with the 4.6 million sf of new supply, these softer demand conditions pushed availability to 8.4 percent, the highest level since 2000. Much of the weakness in Edmonton is concentrated in small bay space which caters largely to petroleum related manufacturing and other tenants servicing the oil patch. In contrast, larger bay space with superior access to key arterial transportation nodes is continuing to generate healthy leasing activity. Looking ahead, the ongoing slump in the energy sector is likely to keep industrial availability at elevated levels. Although Edmonton has some of the highest industrial lease rates in the country, looser market conditions are likely to result in a material softening of industrial rents going forward.

Industrial Fundamentals



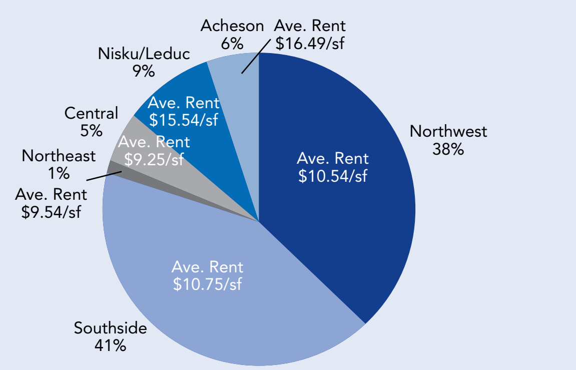
Source: CBRE, Bentall Kennedy, CBRE-EA

Industrial Under Construction *by Sub-Region*



Source: CBRE
**From 2015 Q4*

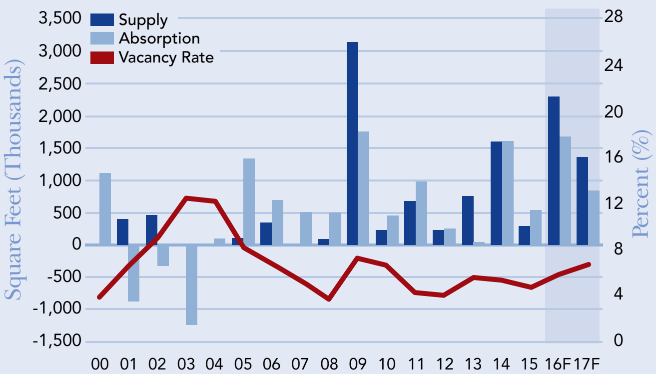
Industrial Breakdown *by Region, Total Inventory 111M SF*



Source: CBRE, Bentall Kennedy

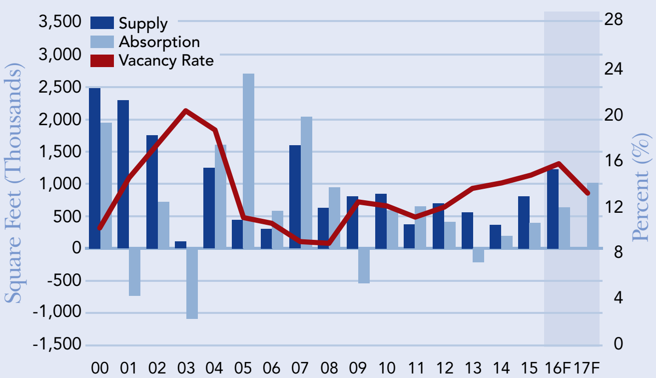
Toronto Office

Class 'A' Office Fundamentals *Downtown*



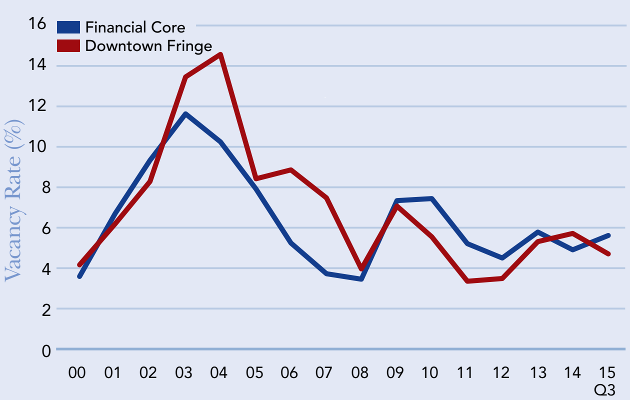
Source: CBRE, Bentall Kennedy

Class 'A' Office Fundamentals *Suburban*



Source: CBRE, Bentall Kennedy

Financial Core and Downtown Fringe *Historic*



Source: CBRE

Economic Drivers

The Greater Toronto region has been one of the better growing economies in Canada over the past year and this trend should continue in 2016. A lower Canadian dollar and robust economic activity stateside should encourage U.S. based firms to engage in capital spending after several years of being idle. This could significantly benefit economic activity in suburban GTA where many U.S. companies have tended to reside. On the back of these favourable economic conditions, income and employment growth should see moderate gains. This should bode well for household consumption which has continued to get an additional lift from low oil prices and the savings at the gas pump. The GTA is also in the midst of a very active commercial real estate development cycle. Together with a hot housing market and increased infrastructure development, construction activity should remain a key economic driver for the region.

Downtown Toronto remains the figurative centre of the GTA and the main hub for transit across the region. As a result, many key office using sectors have increasingly located in this part of the region over the past several years, mainly to gain proximity to key transit nodes such as Union Station. Some traditional suburban tenant groups have also increasingly located in downtown Toronto to attract and retain younger, upwardly mobile workers who tend to live (or enjoy the amenities) in the area. The major banks, a key tenant base in downtown Toronto, have continued to see soaring profits. However, with lending activity at risk of materially slowing down and growing competition from new high tech entrants into the consumer transaction market (known as fintech), the big banks have recently engaged in cost-cutting measures, including consolidation and layoffs. This will likely have a negative impact on employment and output growth in Toronto's key financial services sector over the few next years.

Office Market

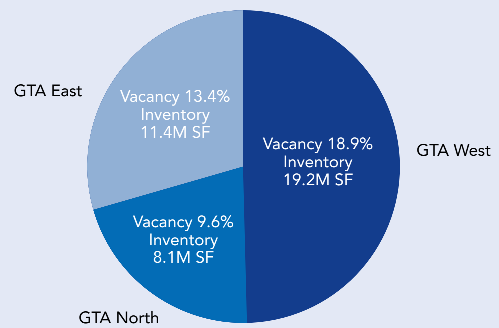
Downtown Toronto remains the tightest office market in the country with average downtown class A vacancy still below its long term average of 6 percent. However, tenants in the Financial District that have committed to the new buildings in the Downtown South node several quarters back are beginning relocations. The vacated office space in generally older class A buildings is now coming back to the market and has yet to be filled, contributing to a growing inventory of available space within the core. With a cost conscious banking sector potentially reducing its space foot print and organic demand growth relatively weak, finding replacement tenants for the back fill space is likely to remain a challenge for landlords over the next few years.

Average downtown class A office rents declined by approximately 6 percent over the past year. To be sure, lease inducements and other provisions have increased as landlords of existing space continue to compete against the 3.6 million sf of new space that will be delivered to the downtown market over the next two years. Given the more moderate pace of underlying office demand, the additional space is expected to put upward pressure on downtown class A office vacancy to around 7 percent by 2017 and shift overall market conditions back into the favour of tenants. This implies that average rents, mainly in older, less efficient and/or less competitively located buildings, will continue to experience downward pressure in 2016.

Leasing activity in the GTA suburban office market has been considerably weaker than its downtown counterpart in recent years. This is partly attributed to weak organic growth stemming from the lingering effects of the last recession. Some traditional suburban tenants, particularly U.S. branch offices, have taken on little space due to the sluggish U.S. recovery in the years following the recession.

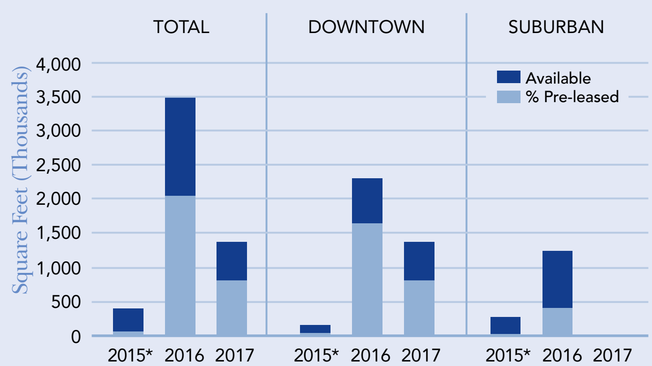
Looking ahead, employment growth in Toronto is expected to gain more traction, especially in sectors that typically support suburban office demand, such as tech and health care. With economic growth south of the border expected to pick up, suburban tenants with strong ties to the U.S. economy could potentially expand their space needs after years of being cautious. Although these emerging trends should be supportive of the suburban office market going forward, the challenge will be for demand to offset the 1.2 million sf of new supply poised to come online in 2016. As a result, suburban office vacancy could continue to remain elevated over the near term.

Class 'A' Suburban Markets *Q3 2015*



Source: CBRE

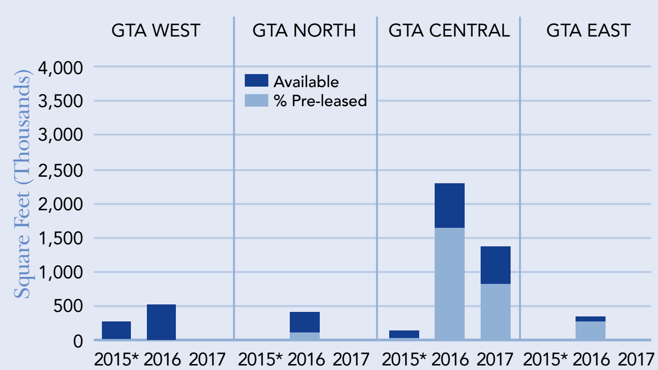
Class 'A' Office Under Construction *by Completion Date*



**Completions For 2015 Q4*

Source: CBRE

Class 'A' Office Under Construction *by Completion Date*

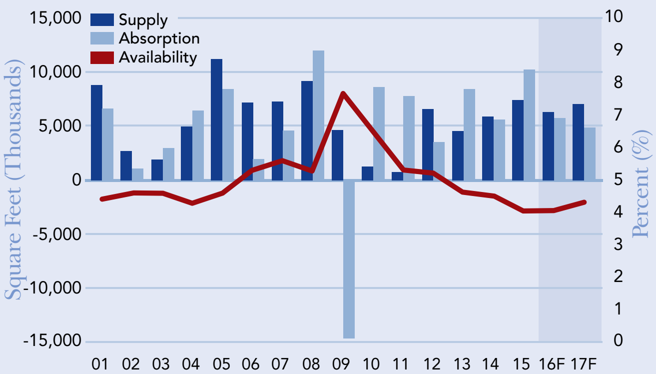


**Completions For 2015 Q4*

Source: CBRE

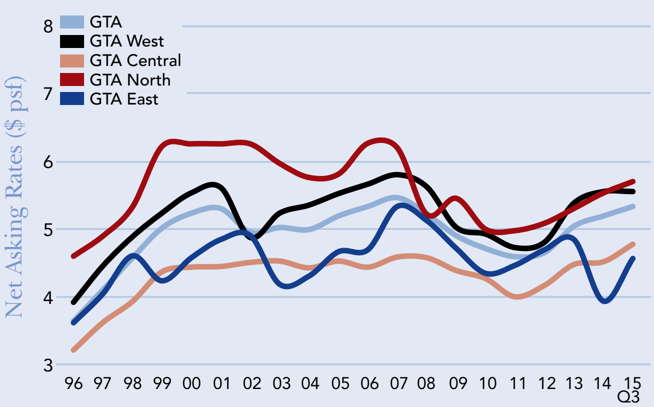
Toronto Industrial

Industrial Fundamentals



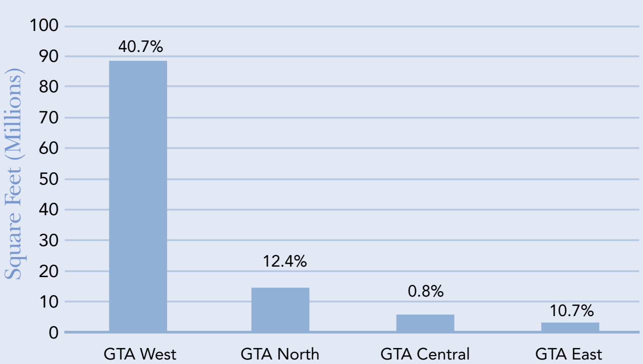
Source: CBRE, Bentall Kennedy, CBRE-EA

Change in Rental Rates *Sub-Market*



Source: CBRE

Increase in Inventory *by Sub-Market, 1997 - Q3 2015*



Source: CBRE

Economic Drivers

As the national economy continues to focus on non-commodity exports to drive overall growth, large industrial hubs such as the GTA will continue to play a key role. In particular, the GTA's export-intensive manufacturing sector should be an important source of growth due to its strong link to the U.S. economy, the region's main trading partner. Together with moderate retail spending, improved manufacturing output should also help to support logistics and distribution activity across the region. With the weaker Canadian dollar, capital spending among U.S. companies that operate in the GTA could materially improve. On the other hand, the weaker loonie could pose some risks to companies that rely on production inputs from abroad, as their profit margins are squeezed due to higher import costs.

Industrial Market

With availability at a historic low, the GTA is one of the tightest industrial markets in North America. Business confidence has generally improved throughout the GTA in 2015 and some companies have been looking to expand their warehousing facilities. Similar to other major markets, the rise of e-commerce has been a key source of demand for industrial space in recent years. As many retailers integrate their distribution channels, demand for large format industrial space could remain strong despite the hit to their margins from the lower Canadian dollar.

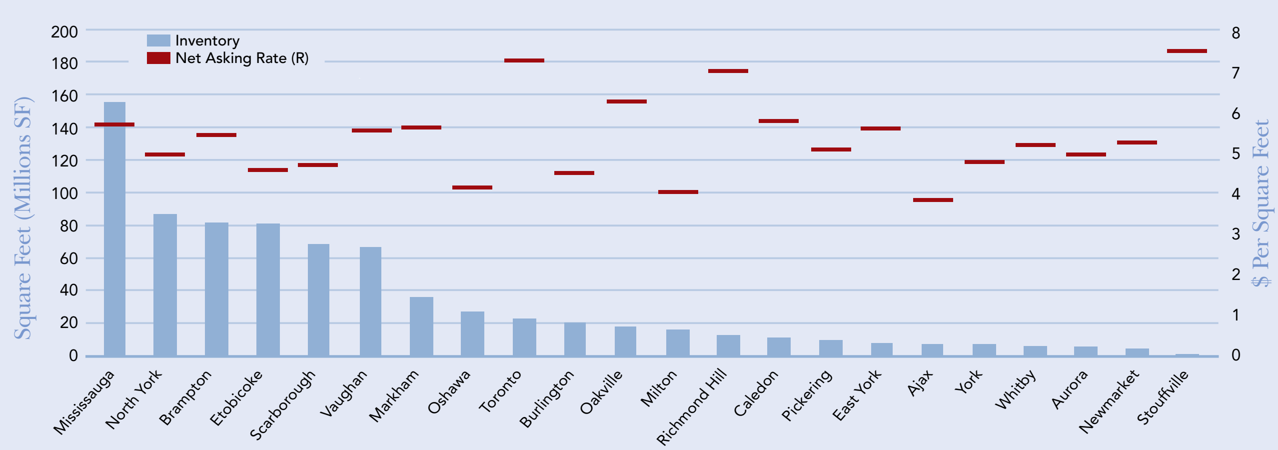
Regionally, GTA industrial demand was broadly based with availability falling across all four submarkets. The GTA West was the most active. With the largest inventory of newer generation product and 6.1 million sf of space currently under development, the West End has been, and should continue to be, the preferred market for warehousing and distribution facilities. This market is also home to many U.S. based firms that might be looking to expand their space footprint in the upcoming years, and this could provide an additional lift to industrial demand. The GTA North has also received a healthy share of leasing activity, especially within the Vaughan node where tenants were willing to pay a premium for high quality industrial space with superior access to Highway 400. As a result, average rents in the GTA North have increased forcefully, and are among the priciest in the GTA.

With an availability rate below 3 percent, the GTA Central is the tightest industrial market. With little serviceable land and steady demand from tenants that have a preference to operate within close proximity to the core, this market continues to see availability rates fall despite a large inventory of older product. Although not as strong as the West End, conditions in the GTA East remain fairly stable, with markets such as Durham garnering attention from cost conscious tenants attracted to its low rents.

Average industrial rental rates in the GTA experienced healthy gains over the past year and currently average $5.30 psf. Not surprisingly, large bay product with 26’ or above clear heights are the priciest at $6.00 psf and have seen the sharpest year-over-year growth of approximately 7 percent. Looking ahead, average industrial rents should continue to register healthy gains, especially in the West End where strong demand conditions should translate into further rental growth.

Overall, macro fundamentals are likely to continue supporting the GTA industrial market over the next couple of years. Although the development pipeline is fairly active with 5.4 million sf under construction, it only accounts for less than 1 percent of total inventory, so it is not expected to disrupt market conditions significantly. However, a big question for the GTA industrial market is how a lower Canadian dollar will impact the profit margins of some import-intensive industries like the distribution sector. If it constrains leasing demand from this key user group, then it almost certainly suggests that the GTA industrial market has peaked.

GTA Industrial Inventory and Asking Lease Rates, *Q3 2015*



Source: CBRE

Toronto Industrial

Fig. 5.1
Greater Toronto Area Industrial Sub-Market Statistics - As of Q3, 2015

	INVENTORY (000's SF)	# OF AVAILABLE BUILDINGS	AVAILABILITY RATE (%)	YTD OVERALL ABSORPTION	AVERAGE NET RENTAL RATE ($ average)	AVERAGE TMIs* ($)
Bolton/Caledon	11,567,499	11	14.7	274,459	5.79	2.44
Brampton	81,875,724	65	5.1	1,985,383	5.44	3.03
Burlington	20,771,222	29	5.8	-122,464	4.51	3.19
Milton/Halton Hills	16,091,821	10	6.2	243,689	4.04	2.52
Mississauga	155,883,277	170	4.9	324,138	5.70	2.81
Oakville	18,111,186	14	3.0	192,314	6.27	3.30
WEST	**304,300,729**	**299**	**5.3**	**2,897,519**	**5.55**	**2.81**
East York	7,991,140	3	0.7	53,362	5.60	5.30
Etobicoke	81,254,171	62	3.4	159,444	4.57	2.70
North York	87,026,467	70	2.3	281,855	4.96	3.63
Scarborough	68,184,630	65	3.1	97,093	4.71	3.66
Toronto	23,064,534	6	0.6	199,179	7.27	3.78
York	7,179,602	3	2.5	-138,478	4.77	2.72
CENTRAL	**274,700,544**	**209**	**2.6**	**652,455**	**4.78**	**3.28**
Aurora	5,458,420	1	3.9	-82,891	4.95	2.50
Markham	35,656,424	31	3.0	56,442	5.63	3.57
Newmarket	4,603,658	11	18.7	-311,970	5.26	2.69
Richmond Hill	12,756,685	16	5.6	679,132	7.01	3.87
Vaughan	66,708,931	51	3.6	981,368	5.55	3.47
Stouffville	988,775	1	1.2	-2,067	7.50	3.50
NORTH	**126,172,893**	**111**	**4.2**	**1,320,014**	**5.70**	**3.38**
Ajax	7,499,341	6	3.0	51,456	3.85	3.46
Oshawa	27,093,966	7	3.5	-91,437	4.16	3.31
Pickering	9,457,322	8	3.9	451,828	5.08	3.50
Whitby	6,092,186	5	9.7	-70,340	5.19	3.04
EAST	**50,142,815**	**26**	**4.2**	**341,507**	**4.57**	**3.28**
TOTAL	**755,316,981**	**645**	**4.1**	**5,211,495**	**5.33**	**3.05**

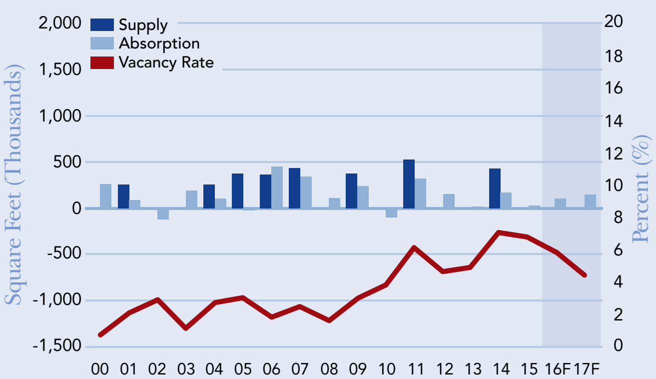
**Taxes, Maintenance & Insurance*

Source: CBRE

World Exchange Plaza, Ottawa, ON
(Owner: bcIMC)

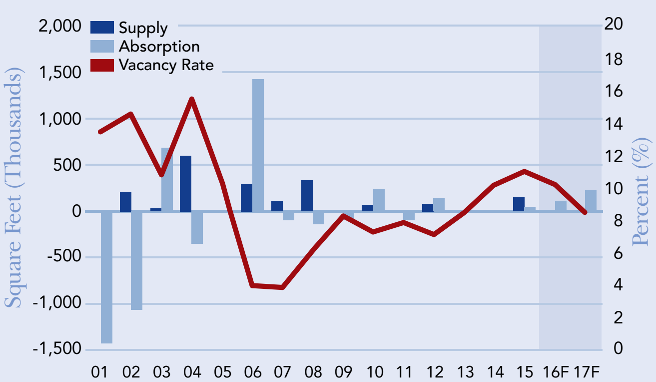
Ottawa

Class 'A' Office Fundamentals *Downtown*



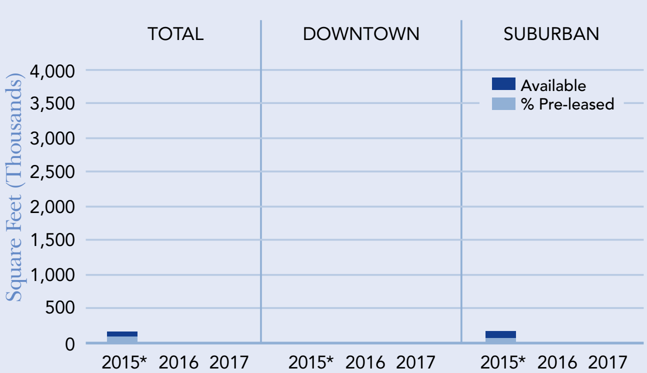
Source: CBRE, Bentall Kennedy

Class 'A' Office Fundamentals *Suburban*



Source: CBRE, Bentall Kennedy

Class 'A' Office Under Construction *by Completion Date*



**Completions For 2015 Q4*

Source: CBRE

Economic Drivers

Most of the federal government austerity measures that were implemented over the past four years are winding down, resulting in less of a drag on Ottawa's economy. As such, economic activity in Ottawa is expected to slowly improve over the next couple of years. The election of a new federal government will also provide some renewed stability to the Capital region and could alleviate the cautiousness that hung over the private sector in recent years. Over the longer term, the new Liberal government could usher in an era of higher fiscal spending which would likely benefit public administration, the main office tenant base in downtown Ottawa.

Ottawa's tech sector continues to mature and has been a dependable source of employment for the private sector in the region. With a growing mandate to diversify the national economy towards more value add industries, the new government plans to further invest in the tech sector and this should support many local area tech firms. Other potential areas of support for Ottawa's economy include various ongoing infrastructure projects such as the $2.1 billion light rail transit network.

Office Market

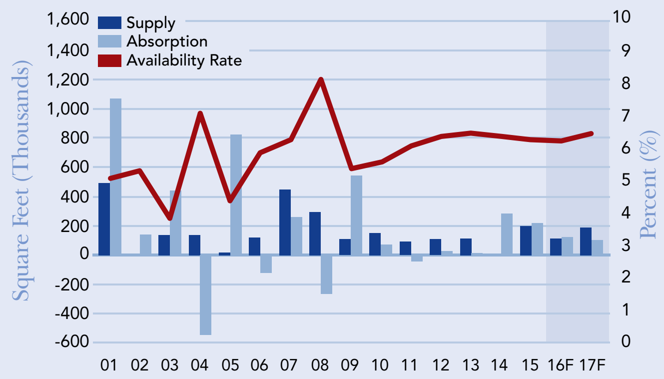
Public sector downsizing weighed heavily on downtown office demand in Ottawa over the past several years. Private sector tenants remained hesitant to commit to any new space in 2015 given the uncertainty of the federal election results. The class B office market was impacted the most with very little leasing activity and rising vacancy. With average downtown class A office rents at their lowest level since the 2009 recession, some tenants took advantage of discounted rates and upgraded their premises to higher quality space. Looking ahead, the new Liberal government should help to spur stronger government demand for office space as fiscal spending increases. Meanwhile, the completion of the LRT network could potentially attract some fringe tenants with previous mobility constraints to relocate closer to the core. This will be especially true for buildings that are well integrated with the LRT line. These favorable conditions suggest that the prospects of Ottawa's downtown office market look better heading into 2016 compared to recent years.

Ottawa's suburban class A office market continued to struggle with vacancy in the double-digits at the end of 2015. After a very slow start to the year, the Deep West improved and has been the most active submarket. Kanata, the largest node within the Deep West, was the preferred region for several tech tenants looking to either expand or upgrade their premises. Conditions in the West submarket were steady with modest leasing activity, but the East and South submarkets continued to underperform with vacancies well above their long term averages.

Industrial Market

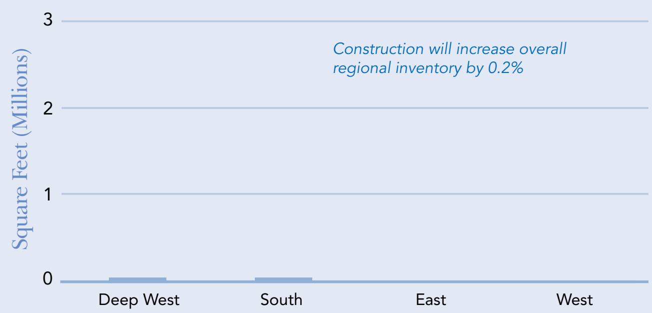
Ottawa's relatively small industrial market saw decent leasing activity over the past year. However, absorption levels were not enough to offset the 192,000 sf of new supply and industrial availability increased modestly in 2015. The Deep West continued to outperform and was where the majority of the leasing activity took place. It was also the preferred destination for design-built and owner-occupied industrial space in Ottawa. Conditions in the remaining submarkets were muted, especially the East end where a rise in sublease space contributed to elevated availability. Due to the limited supply of high quality space, industrial rents in Ottawa continue to average around the $8.75 psf mark, making it one of the priciest industrial markets in the country.

Industrial Fundamentals



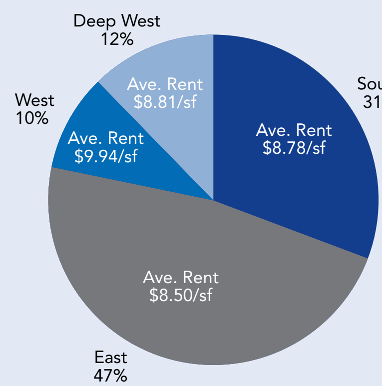
Source: CBRE, Bentall Kennedy, CBRE-EA

Industrial Under Construction *by Sub-Region*



Source: CBRE
**From 2015 Q4*

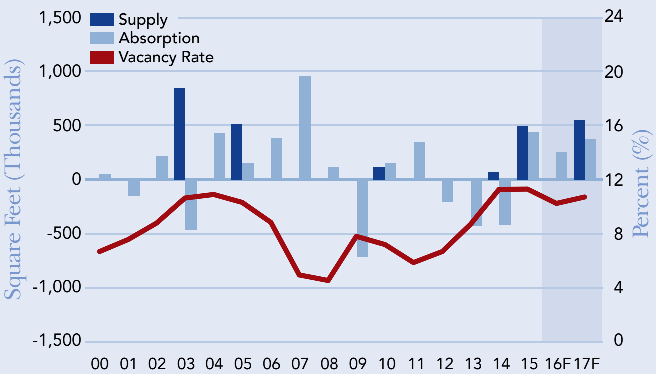
Industrial Breakdown *by Region, Total Inventory 30M SF*



Source: CBRE, Bentall Kennedy

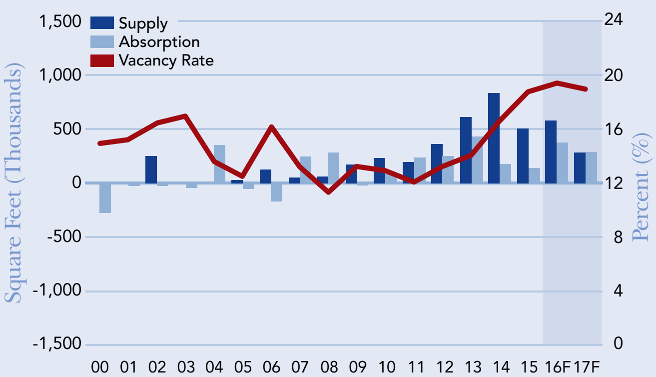
Montreal

Class 'A' Office Fundamentals *Downtown*



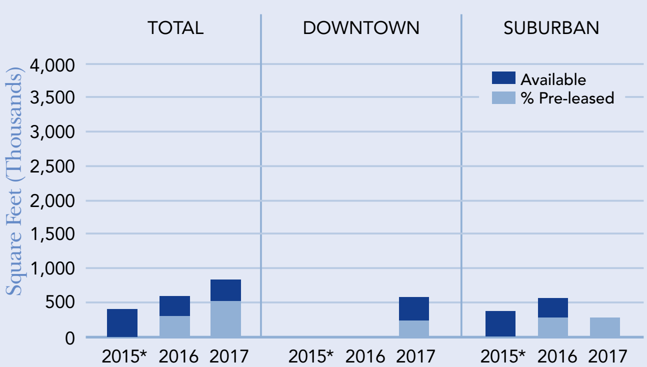
Source: CBRE, Bentall Kennedy

Class 'A' Office Fundamentals *Suburban*



Source: CBRE, Bentall Kennedy

Class 'A' Office Under Construction *by Completion Date*



**Completions For 2015 Q4*

Source: CBRE

Economic Drivers

The outlook for Montreal's economy is improving with real GDP growth expected to outperform the national average. Montreal's manufacturing sector is poised to see the biggest improvements and will be a key driver of overall economic output, especially as a weak Canadian dollar and stronger U.S. demand supports regional export activity. Offsetting this, to some extent, is the struggling aerospace sector, where ongoing production delays could potentially result in further cost cutting measures.

Population growth and housing demand are expected to be moderate growth drivers for Montreal over the medium term. Residential construction activity is expected to take a breather this year following several years of robust activity. Fortunately, several ongoing infrastructure projects throughout the city should offset the slowdown. In tandem with a more favourable economic outlook, employment growth in Montreal should remain relatively stable. Given the local economy's reliance on manufacturing and export activity as well as its position as a key logistics hub, much of the employment growth is likely to take place within the trade sector.

Office Market

Following three consecutive years of negative absorption, leasing activity in Montreal's downtown class A office market modestly improved in 2015. There has been very little supply over the past decade and the lack of quality space encouraged some tenants to migrate to surrounding markets. As a result, downtown class A office vacancy steadily increased over the past few years. Despite this upward pressure on vacancy, average net rents have held up relatively well, especially in comparison to the national average. While other office markets in Canada have seen far better rent growth in the last decade, the relative stability of Montreal's downtown office market is an important dynamic to keep in mind.

Although downtown Montreal currently has 750,000 sf under construction, its relative pace of development pales in comparison to other major downtown markets.

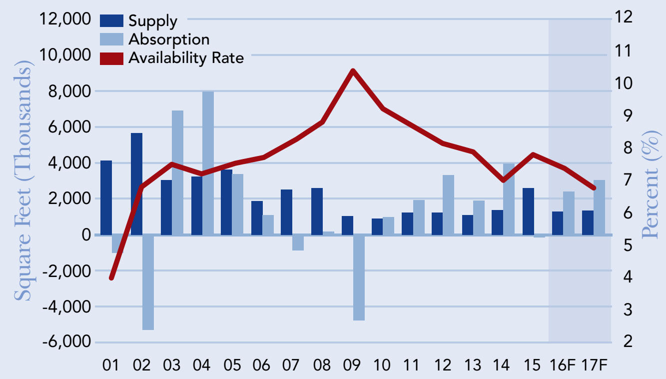
The increase in available space should alleviate some pent up demand and encourage more tenants to either expand or relocate to the core. As such, we expect 2016 to be a steady year for Montreal's downtown office market.

Montreal's suburban office market has benefited from an influx of traditional downtown tenants escaping the congestion caused by ongoing infrastructure projects near the core. On balance, the Midtown submarket has been one of the best suburban performers given its close proximity to transit. However, leasing activity in this market has not been enough to keep up with the steady flow of new supply. As a result, suburban class A office vacancy continued to increase and surpassed its long term average of 14 percent at the end of 2015. Looking ahead, the influx of traditional downtown tenants to the Montreal suburbs is likely to subside as more space options become available within the core. This, together with approximately 600,000 sf of new space to arrive on the market is likely to keep vacancy elevated in the suburbs.

Industrial Market

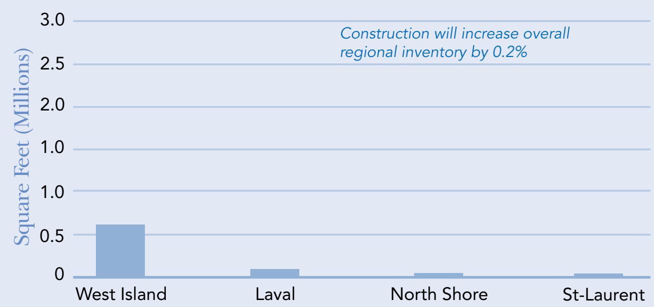
Although still below its long term average, Montreal's industrial availability rate moderately increased in 2015. While leasing activity was weaker, much of the upward pressure was supply driven as 3 million sf of new space (most of which was speculative) arrived on the market – the most in nearly a decade. Similar to other central Canadian markets, the steady flow of new supply has been driven by improving industrial net rents, which increased by 2-3 percent to approximately $5.30 in 2015 – the highest in six years. Looking ahead, economic forces should remain supportive of industrial demand in Montreal. While a low C$ and stronger U.S. growth should help to drive the region's manufacturing sector, the continued focus of companies to improve efficiency in their supply chains alongside Montreal's strategic position near a major port and rail network, should continue to drive distribution demand. This could help to quickly absorb the new space arriving on the market, particularly off-island along the North Shore. •

Industrial Fundamentals



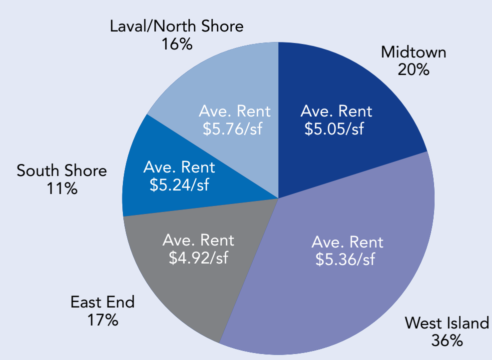
Source: CBRE, Bentall Kennedy, CBRE-EA

Industrial Under Construction *by Sub-Region*



Source: CBRE
**From 2015 Q4*

Industrial Breakdown *by Region, Total Inventory 300M SF*



Source: CBRE, Bentall Kennedy

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(owner: Prime Canadian Property Fund)

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