

# Perspective

2018

CANADA



01 EXECUTIVE OVERVIEW

02 ECONOMIC OUTLOOK

03 CAPITAL MARKETS

04 SPACE MARKET TRENDS



Bentall  
Kennedy

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# Table of Contents

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01 Executive Overview	4
02 Economic Outlook	7
03 Real Estate and Capital Markets	19
04 Space Market Trends	
Office	27
Retail	33
Industrial	39
Multi-Residential	43
About Bentall Kennedy Group	49

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For more information about Perspective, please contact:

Phil Stone, VP, Head of Research, Bentall Kennedy (Canada) Limited Partnership  
pfstone@bentallkenedy.com, 416 681 7955

# Executive Overview:

## Growth to moderate but property fundamentals remain healthy

- Canadian real estate is anticipated to deliver steady income returns in 2018, predicated on stable economic growth and healthy property fundamentals. The Canadian economy outperformed all G7 nations in 2017, a dramatic improvement from the prior two years. While sustained wage growth remains elusive, there has been positive momentum since April as the labour market continues to tighten, with an impressive rate of full-time job creation. Wage growth will be critical to the health of consumer spending in 2018 as households adapt to a higher interest rate environment and the effects of a cooling housing market.
- For the first time since the Great Recession we're seeing broad-based global economic growth. In 2018, stronger economies in the euro area and Japan, and stabilized growth in China, should exert downward pressure on the U.S. dollar, helping to extend the U.S. expansion. In response, central banks have begun to tighten monetary policy in North America and the U.K., and expectations are that the European Central Bank will follow suit if the current pace of growth persists.
- A wide array of geopolitical risks remains and further escalation could downgrade the outlook for global growth. While national populism has lost some momentum, stagnating middle class wages ensure this movement will continue to simmer. The U.S. expansion pushes on, with a robust labour market nearing full employment, but skill mismatches are increasingly hindering growth as firms are challenged to fill open positions, especially under more stringent U.S. immigration policies.
- NAFTA renegotiations and the impact of tax reform in the U.S. are downside risks to Canadian competitiveness, and ultimately business investment and trade. Synchronized global growth should help extend the U.S. expansion and, by extension, Canada, but we expect Canadian growth to return to a more moderate pace in 2018.
- Property fundamentals across Canada are healthy with the exception of the Alberta office markets and certain categories of retail. The current real estate market is characterized by far less speculative development and lower debt levels than previous cycles, providing a cushion should conditions worsen. Given the later stage in the business cycle, however, future rent growth must be expected to moderate. In this environment it will be more critical than ever for investment managers to be proactive with their assets in order to drive net operating income growth. This is especially true as the low interest rate environment that has compressed cap rates to record lows shifts in to the rear-view mirror.
- Notwithstanding the strong pricing environment, investment volumes remain robust as investor demand for yield continues to draw capital to the asset class, exerting downward pressure on cap rates. This weight of investor capital combined with healthy space market fundamentals bodes well for property values in most sectors and geographies even in a modestly rising interest rate environment.
- The office sector remains a tale of two markets. Although we are seeing signs of an economic recovery in Alberta, we are far removed from "balanced" conditions in Calgary and Edmonton. Demand recovery in the province is anticipated to be more modest than in prior cycles as the market will have to absorb the glut of new inventory delivered during the last development cycle. Meanwhile, the markets in Toronto, Vancouver and Montreal continue to tighten with a rapidly growing tech tenant base along with steady demand from traditional users.
- The retail landscape continues to evolve at a torrid pace. While 2017 was a strong year for retail sales, higher interest rates and elevated debt levels could weigh on consumer spending going forward. Notwithstanding solid retail sales growth, mall sales growth was quite modest in 2017, with significant inroads being made by ecommerce. Changing consumer preferences and aging demographics are also significant headwinds that are anticipated to persist. It is not, however, all "doom and gloom" as headlines might suggest. Urban and necessity-based retail formats continue to thrive. Luxury and value-oriented retail segments are still attracting shoppers and generating positive same-store sales growth. Ultimately, shoppers are looking for a compelling reason to visit a shopping centre which increasingly involves an experiential component such as food or entertainment. But above all, retail is undergoing a structural shift where physical stores are becoming a critical, visceral component of the overall brand experience rather than simply a vessel for transactions.
- Industrial real estate is the primary beneficiary of the transformation occurring in retail. There is strong demand for warehouse and distribution space as retailers re-tool supply chains in order to support retailing across multiple channels. Demand for warehouses with modern design, functionality and great access to transportation networks continues to exceed available supply. Falling availability

is driving strong rent growth across most markets, particularly in Toronto and Vancouver where vacancy is at historic lows. For tenants, it's becoming increasingly important to be close to major population centres to cut down on delivery time and costs to the end consumer. Expect continued demand for distribution and logistics space in the year ahead as ecommerce in Canada is still in its infancy.

- The demand drivers for purpose-built rental properties are intensifying. Strong employment and educational opportunities along with an "open door" immigration policy is fueling population growth in major urban centres. While deteriorating affordability in Toronto and Vancouver is forcing many households to rent out of necessity, increasingly many are choosing to rent as a lifestyle preference. This growing segment of the market is broad-based across sociodemographics, which bodes well for sustainable rental demand. These households are typically willing and able to pay a premium for the benefits provided by modern apartments with high quality finishes and amenity offerings.

**We remain optimistic about the outlook for the economy, property markets and investment returns in 2018. We are mindful, however, of the uncertainty around tighter monetary policy, potential trade wars, heightened geopolitical risks and the emergence of disruptive technologies and how these dynamics may impact the commercial real estate market. Our top-down macroeconomic and investment analysis combined with "boots on the ground" insight provides us with a discerning perspective on the issues at hand. We hope you find our views insightful and informative.**



Tour KPMG,  
Montreal



B5



bdc



Bentall 5, Vancouver

# Economic Outlook

# 02

## GLOBAL

- Stronger business confidence and improving industrial production driving synchronized global growth
- Quantitative easing is finally having the desired effect; central banks transitioning toward tighter monetary policies
- Populist movement losses momentum but risk of disruption remains
- Elevated geopolitical risks could downgrade the outlook for global growth

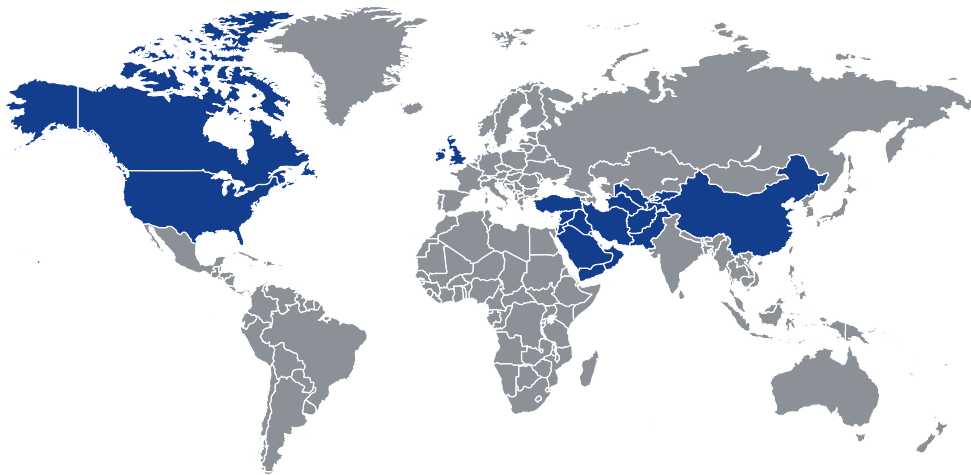
## U.S. ECONOMY

- U.S. economic expansion continues aided by improving global conditions
- Consumers are benefitting from a tight labour market and wealth effects from record stock prices and home values
- Skills mismatch in the labour market should continue to put upward pressure on wage growth
- Policy risks remain, including tax reform, healthcare law, and the renegotiation of trade agreements

## CANADA

- Economy rebounds but growth easing to a more sustainable pace
- Labour market producing jobs at an impressive rate - wage growth gaining traction
- Bank of Canada raises interest rates but likely to take a “wait and see” approach in 2018
- Housing market correction and NAFTA adds uncertainty

# Global Economy: Improving outlook reduces the need for monetary stimulus



The global economy is on better footing as we head into 2018. Prospects for the euro area have improved as rising business and consumer confidence drive widespread growth across most member countries. Meanwhile, a rebound in industrial production foreshadows brighter times ahead for emerging markets, especially

in China where growth has stabilized. Expansionary fiscal and monetary policies that were put in place in recent years are beginning to have a positive impact on the real economy. This trend is expected to persist in 2018, with the U.S. and Canada holding their own among advanced economies.

## CENTRAL BANKS TIGHTEN MONETARY POLICIES

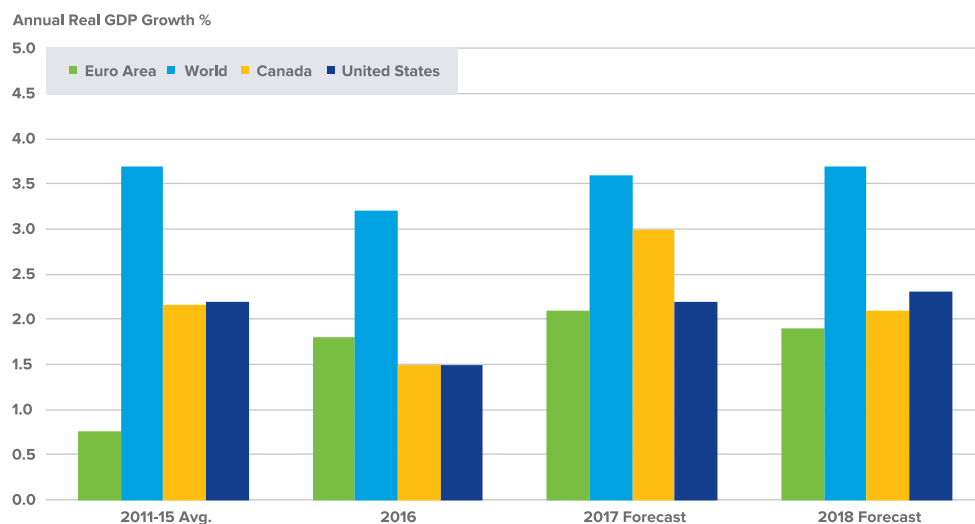
With the improving global outlook, central banks are transitioning to less accommodative regimes after a prolonged period of stimulus, albeit at varying degrees. This is echoed by the Federal Reserve's unwinding of quantitative easing (QE) in an attempt to normalize its balance sheet, which is likely to be followed by further interest rate hikes. It is expected that the Federal Reserve will maintain its current course under new chairman Jerome Powell.

The Bank of England recently raised its benchmark rate for the first time in a decade, but the U.K.'s looming exit from the European Union and its impact on the U.K.'s economic ties with neighbouring trade partners could cause it to tread with more caution. With healthier economic conditions across continental Europe, the European Central Bank has become less dovish and is expected to taper the current quantitative easing program as well.

Meanwhile, the Bank of Japan is still committed to keeping its 10-year yield near zero, but consistent economic growth and improving employment conditions could open up doors for tighter monetary policies in the medium term. The Bank of Canada raised the overnight rate on two occasions in 2017 Q3 as the Canadian economy accelerated.

All told, gradual winding down of monetary stimulus is a credible vote of confidence that the global economy is improving. However, we expect central bankers to be cautious as inflation remains low, reflecting the fact that aggregate demand is still not forceful enough to drive consistent price and wage growth.

## 2.1 GLOBAL GROWTH CONTINUES



SOURCE: IMF



# 3.7%

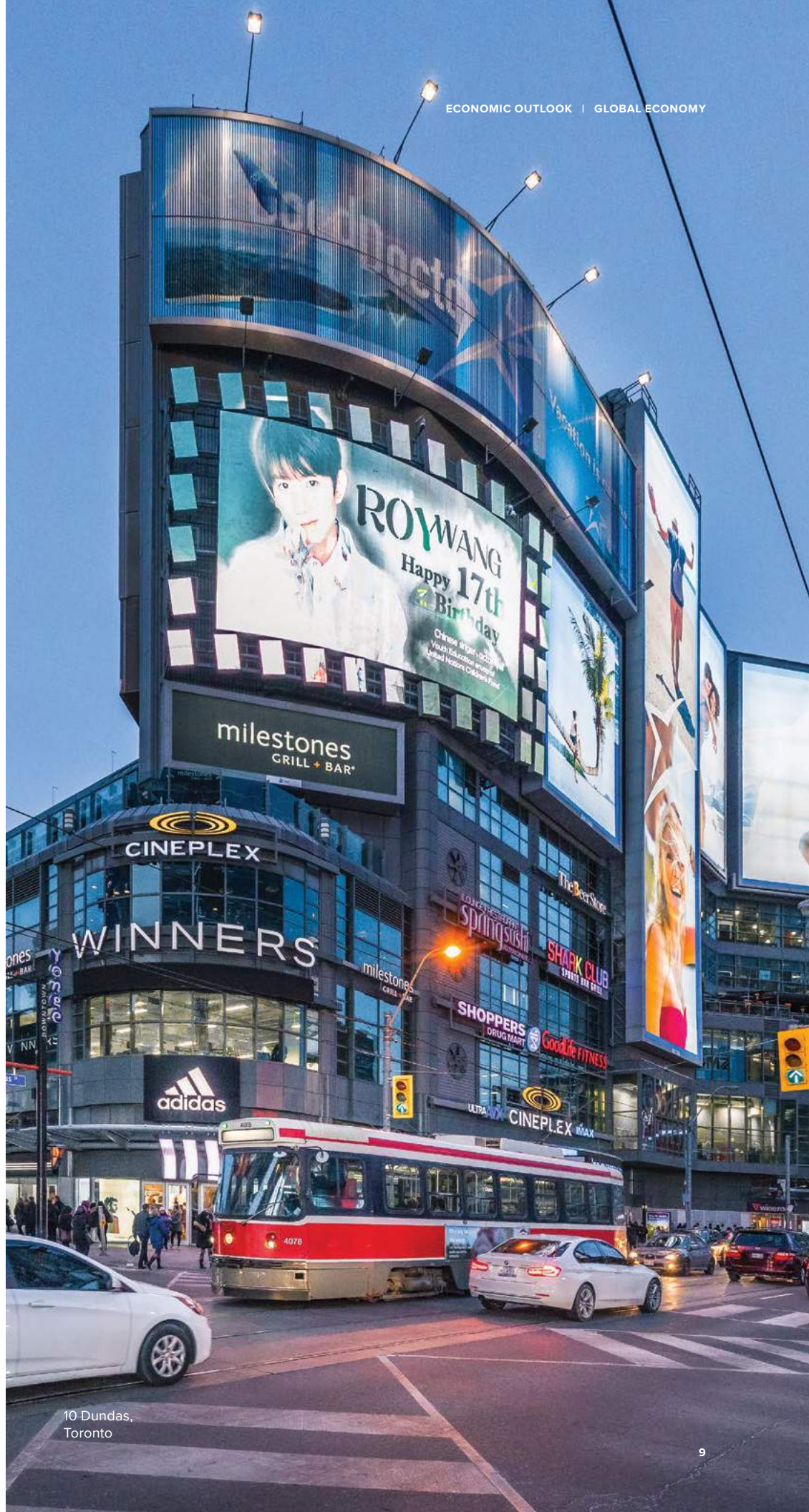
PROJECTED GLOBAL GDP GROWTH  
FOR 2018; SOURCE: IMF

## POPULIST MOVEMENT LOSES MOMENTUM

Populist sentiment that initiated Brexit and assisted in placing the Trump administration in the White House lost some momentum in 2017, thanks in large part to the rise of France's Emmanuel Macron and the re-election of Angela Merkel. However, Germany is showing signs of political unrest due to opposing views on immigration. This dissension could spark a new election causing further political uncertainty.

While the contention between populism and globalism appears to be contained for the time being, it remains a potential source of disruption as technology and globalization place mounting pressure on the working class. Brexit negotiations and the outcome of Italy's election will be key indicators in 2018.

The state of this populist movement not only has great social implications, it could have far-reaching impacts on the global economy, especially as it pertains to the negotiation of global trade policies. With global economic conditions improving but still tentative, any headwinds impacting trade flows could downgrade the outlook.



10 Dundas,  
Toronto

**CHINA IS A KEY COMPONENT TO GLOBAL GROWTH**

While consensus projections of China’s GDP growth in 2017 are in line with the policy target of 6.5 per cent, this is far removed from the double-digit growth of years past that solidified China as one of the largest economies in the world. Economic progress in 2018 is largely dependent on how successful the government will be in regulating the scorching housing market. However, it appears that policies aimed at curbing investor speculation are having the desired effect as home price growth is losing momentum. Moreover, strict measures to contain outflow of capital by the central government could redirect corporate investments back into China

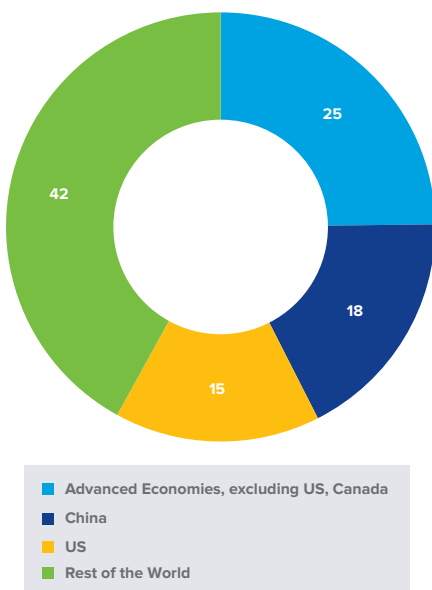
and provide support to the economy. But these measures also pose a threat to asset values abroad, which have benefited from capital outflows from China.

A key source of Chinese economic growth through most of 2017 was debt-driven consumption, which is likely to unwind as the central government raises interest rates in an attempt to contain excessive borrowing. This makes the Chinese economy vulnerable to a hard landing in the housing market and a sharp correction in household spending. This is not imminent, but given China’s sizable contribution to global GDP, we should be cognizant of these downside risks and their rippling effect through the global economy and financial markets.

Projections of China’s GDP growth in 2017 are in-line with the policy target

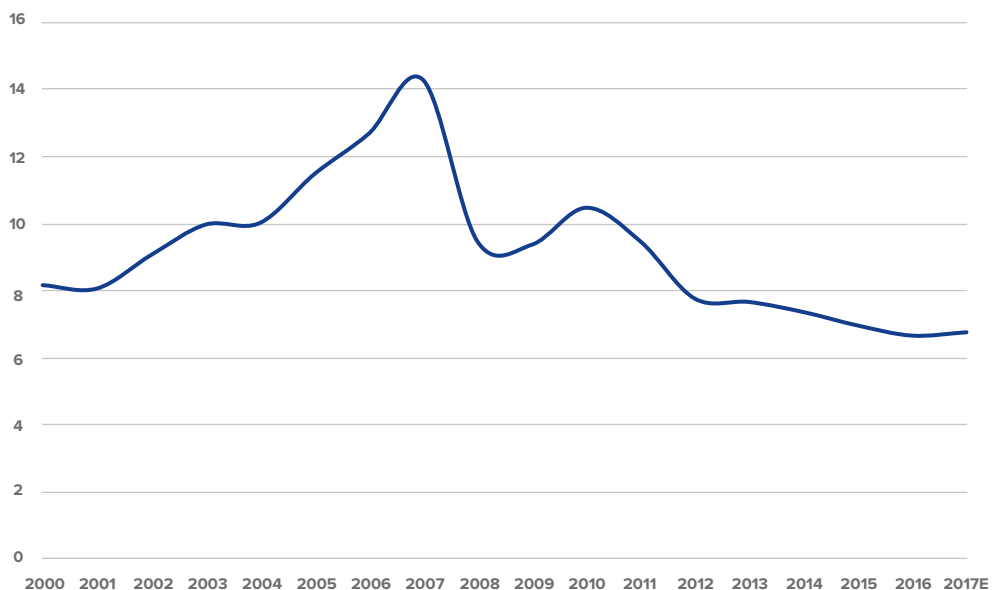
**2.2 CHINA AND US - KEY CONTRIBUTORS TO GLOBAL GDP**

(%)



**2.3 CHINA’S ECONOMY STABILIZING**

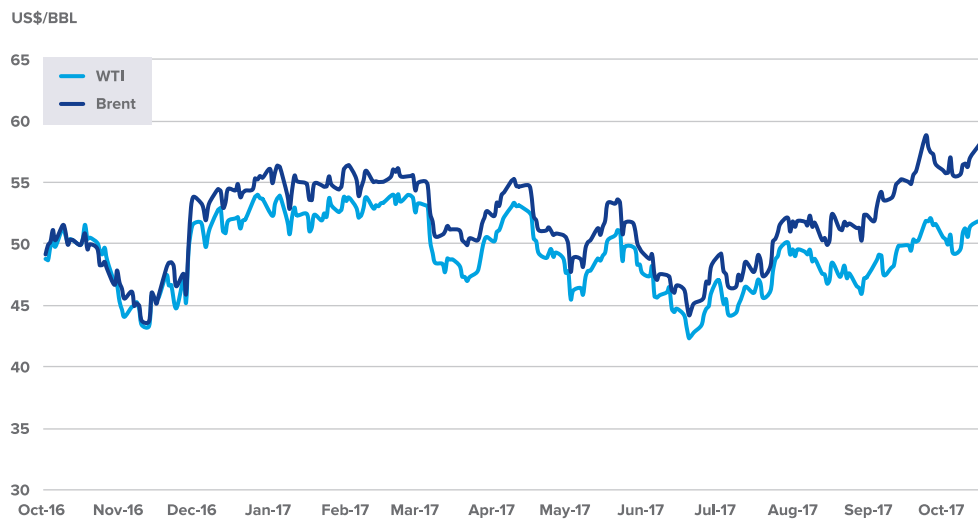
Real GDP Growth (%)



SOURCE: IMF; GDP BASED ON PURCHASING POWER PARITY

SOURCE: CHINA NATIONAL BUREAU OF STATISTICS

## 2.4 CRUDE OIL PRICES GAINED GROUND IN 2017



SOURCE: BLOOMBERG

### CRUDE PRICES REMAIN LOW DESPITE RECENT GAINS

Commodity prices have been on an upward trend through much of 2017 and should continue to see healthy gains on the back of stronger manufacturing and industrial output. Forestry, metal and mineral related goods have all registered material price gains as of late. While crude oil prices are still around the \$50 – \$60/bbl range, Brent and WTI prices have been trending upward since mid-2017, a positive sign that could reflect a rebalancing of market conditions.

The outlook for oil prices is likely to be contingent on how well OPEC and non-OPEC members can remain committed to coordinated production cuts. This will be a tricky task as the U.S. shale industry continues to benefit from declining production costs and is likely to maintain the current volume of output, creating a disincentive for crude oil producers to dial back production.

### POLITICAL RISKS REMAIN

There is a wide array of geopolitical risks that could weigh on the global economy in 2018. Tax reform in the U.S. could impact other countries where U.S. firms have hoarded cash, while providing a short-term lift to U.S. economic activity — although estimates on the economic impact of legislation have varied greatly. The midterm election provides another element of uncertainty as the restructuring of Congress could alter the direction of governance in the U.S. Moreover, any material setback involving NAFTA negotiations could ripple through trade-oriented sectors such as the automotive industry. Escalating tension with North Korea could negatively impact relations between the U.S. and China, the world's two largest economies. If the situation with North Korea escalates, it could upend global equity markets, which have been on the rise. Outright war on the Korean Peninsula would likely prove disastrous for the global economy.



Sun Life Financial Centre,  
Ottawa

# United States Economy: Expansion pushes on



Economic expansion in the U.S. continues to push forward despite disruptions from severe weather events, notable domestic policy uncertainty and ample geopolitical tensions. Job creation has slowed, due in part to these factors, but also as a result of tightening unemployment and the maturation of the business cycle. Geopolitics may cloud the outlook somewhat, but generally speaking, economic growth abroad is more of a tailwind for the U.S. than it has been at any point since prior to the global financial crisis.

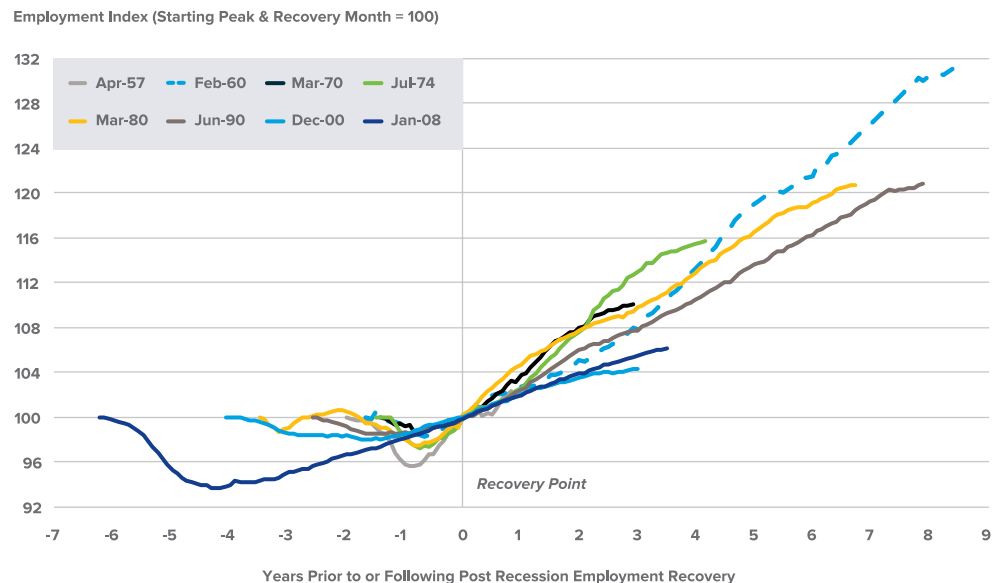
GDP growth has been steady, and it should reach the 2.5 - 3.0 per cent range when finally tallied for 2017. Strong household spending and an uptick in business investment have underpinned this growth. Global conditions and a slight weakening of the US dollar against other currencies versus its December 2016 highs have resulted in a positive contribution from net exports. The industrial production index increased by 3.1 per cent from November 2016 to October 2017 and a strong gain in the Institute for Supply Management's manufacturing index foretells of continued expansion in this area.

Decelerating job growth is evident across a variety of sectors. Employers have been challenged to find workers and initial unemployment claims are running near cyclical lows. Unemployment is 4.1 per cent, which is even lower than the 4.4 per cent achieved in 2007; however, U.S. job growth has certainly not stalled.

Weakening of the U.S. dollar has resulted in a positive contribution from net exports

## 2.5 THE CURRENT ECONOMIC EXPANSION LOOKS RELATIVELY YOUNG

- Employment has been expanding for less than four years
- A shorter period than the Post- 1960, 1974, 1980, and 1990 recession expansions
- Only slightly longer than the Post- 1970 and 2000 expansions
- In percentage terms the expansion is small, at 6.1%
- Four cycles more than doubled this cycle's percent gain in jobs
- This expansion follows the deepest recession and longest recovery period of any of the cycles shown



SOURCES: U.S. BUREAU OF LABOR STATISTICS, BENTALL KENNEDY

# 3.1%

INCREASE IN INDUSTRIAL PRODUCTION INDEX, NOV. 2016 TO OCT. 2017

## REASONABLE PROSPECTS FOR CONTINUED EXPANSION

The question we continue to examine is how much longer the economy can expand as we approach 10 years since the prerecession peak in employment in January 2008. The 1980s (including both the '80 and '82 recessions) and 1990s cycles pushed beyond 10 years and both saw more substantial expansions above prior peaks than what we have experienced since the Great Recession. Perhaps more noteworthy from a time perspective, however, is the relatively short period from when precession peak jobs were regained to today, as shown in Figure 2.5.

Viewed through this lens, the prospects for the U.S. economic expansion to continue for at least a few more years are reasonable. Further, if a recession were to happen over the next five years, we expect it to be relatively mild. The real wild card is labour availability — hence our concerns around any policies that could potentially hinder the flow of skilled labour into the U.S. Unemployment is sub-2 per cent in health care and legal occupations and sub-3.0 per cent in computer, math and engineering fields.

## SKILLS MISMATCH TO CONTINUE TO PUT UPWARD PRESSURE ON WAGES

Headline unemployment likely overstates the labour shortage, but many of the potential workers found in alternative measures of unemployment either lack the skills or are in the wrong location to fill available positions, or both. Labour force participation is down more than three percentage points from 2007 and a return to that level would add eight million people to the labour force. Job training and the migration of jobs to the locations of available labour (and vice versa) will take time.

Labour shortages are putting steady upward pressure on wages and, while wage growth has been somewhat disappointing to date, the trend has been one of slowly accelerating growth. Low unemployment and rising wages are working to inspire robust levels of consumer confidence. An optimistic consumer outlook is further fuelled by rising asset prices as the stock market and home prices push to record highs.

The assets-to-income ratio is near 2007 record levels. U.S. consumers feel optimistic about their employment prospects, personal wealth, and the economy at large and are once again steadily spending down their savings as a result. It should be noted that these trends also create some downside risk for the economy if households are unexpectedly impacted by a sharp correction in the stock market or a decline in home values after a period of decreased saving.

## POSITIVE OUTLOOK FOR U.S. COMMERCIAL REAL ESTATE

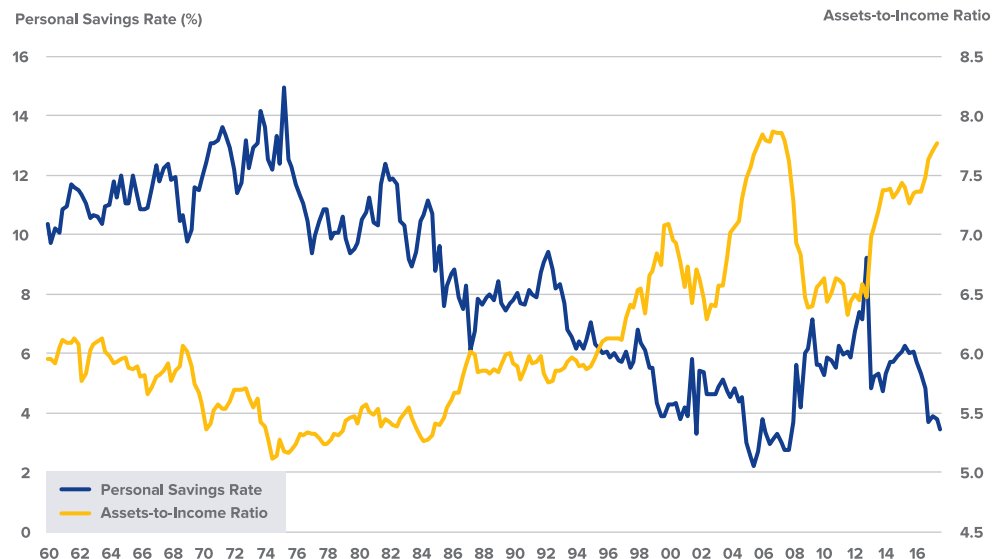
Real estate investment performance will depend heavily on the U.S. economy's ability to generate jobs, encourage people to form new households, and put those households in a position to consume. Recent economic growth has certainly accomplished these requirements, driving

increased demand for all types of space. The underlying dynamics and external factors generating this growth remain intact and, in some cases, enhanced (e.g. stronger global growth). Labour shortages remain a headwind and downside policy risks are significant, including:

- The Fed becoming too aggressive with unwinding highly stimulative monetary policy
- Changes in the tax code overheating equity and commercial real estate markets, hurting residential property values, and driving higher U.S. budget deficits
- Failed brokering of major trade deals, crimping international trade volumes

But if policy-makers can, at the very least, succeed in not harming the economy and conditions abroad remain favourable, the U.S. should grow steadily in 2018, resulting in widespread benefits for commercial real estate investors.

## 2.6 HOUSEHOLD ASSET GROWTH AND A STRONG LABOUR MARKET ARE ENCOURAGING CONSUMER SPENDING



SOURCES: U.S. BUREAU OF ECONOMIC ANALYSIS, FEDERAL RESERVE, MOODY'S ANALYTICS

# Canada Economy: Rebound in 2017 - more sustainable growth on the horizon



The Canadian economy is on pace to grow by 3.0 per cent in 2017, outperforming the G7 average and the U.S. economy. It appears that the economy has recovered from the collapse in energy prices and pent-up demand is beginning to unwind. Much of this recovery took place in Alberta, where output is projected to grow above the 4.0 per cent mark in 2017, the fastest pace among the provincial economies. Despite elevated debt levels, households remain active on the spending front and continued to provide most of the heavy lifting. This dependence on consumption-driven growth is anticipated to ease, especially in a rising-interest-rate environment where households will be allocating more income to servicing debt.

Fortunately, other facets of the economy are poised to pick up the slack. After being relatively idle over the past couple of years, businesses appear to be less cautious with hiring and capital expenditure, reflecting a more positive outlook. Buoyed by stronger global output, demand for natural resources is improving and this should benefit the important commodity sector. Meanwhile, fiscal spending should also continue to provide additional support to economic activity.

While this strong showing over the past year signals that the Canadian economy is heading in the right direction, real GDP growth is likely to ease to a more sustainable pace of around 2.0-2.5 per cent in 2018.

## LABOUR MARKET ON A ROLL

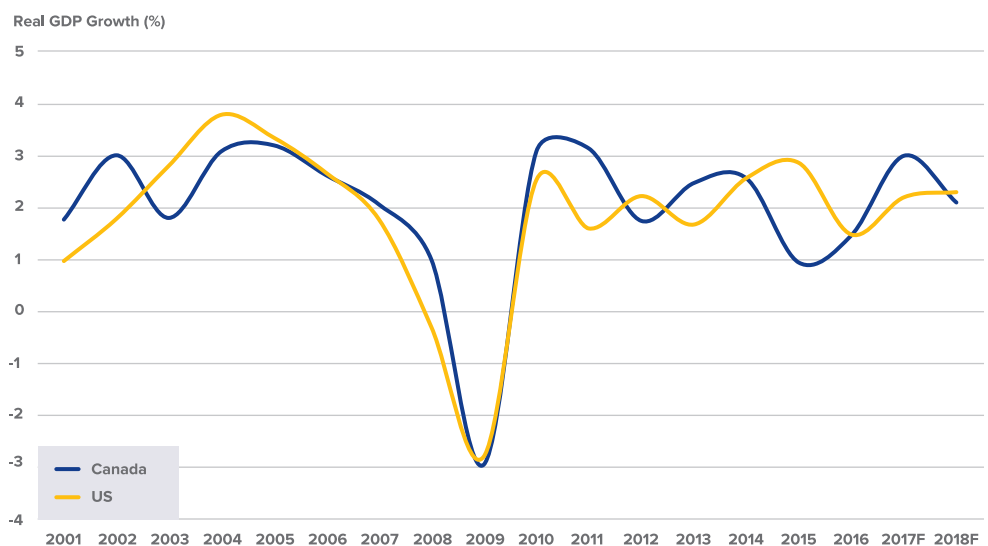
Most indicative of Canada's improved economy is the impressive rate of job creation. Through 11 months, approximately 344,000 jobs were added and barring any significant setback, the total volume for 2017 will surpass the 300,000 mark for the first time in a decade. But what is more encouraging is the whopping 371,000 full-time jobs that were created over the same period. Net change in full-time and part-time employment are negatively correlated, with part-time employment outperforming through down cycles. During periods of tepid growth, employ-

# 3.0%

EXPECTED GDP GROWTH FOR CANADA IN 2017; SOURCE: IMF

ers utilize part-time employment as a hedge against uncertain or weak business conditions. By contrast, when outlook improves, they will shift their preference to full-time employment in anticipation of stronger business activity. As such, full-time employment growth is a key forward-looking indicator and this solid showing means that the economy is in better health as we head into 2018.

## 2.7 CANADA ON TRACK TO OUTPERFORM THE US IN 2017



SOURCE: IMF

Most indicative of Canada's improved economy is the impressive rate of job creation

# 371K

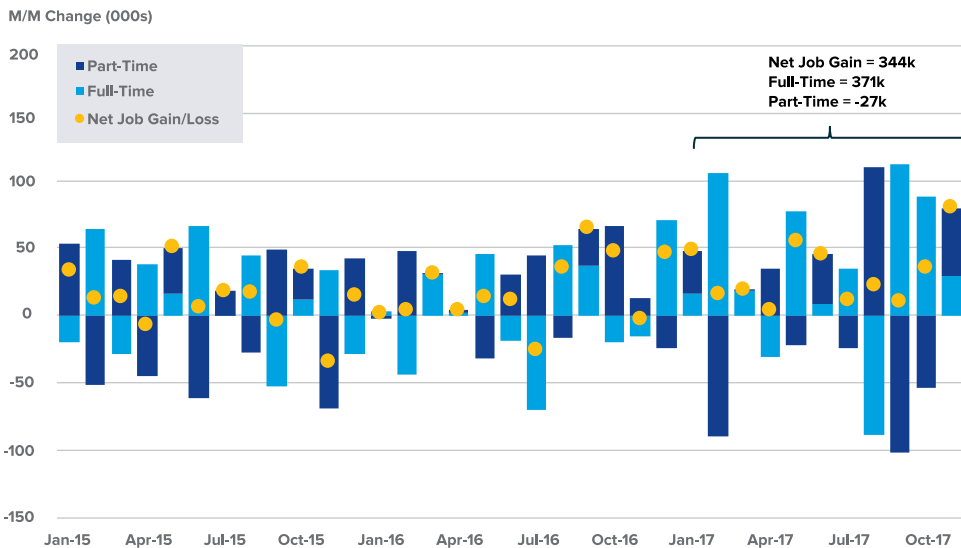
YTD FULL-TIME JOBS CREATED AS OF NOV 2017; SOURCE: STATISTICS CANADA

**BANK OF CANADA RESTORES OVERNIGHT RATE TO 1 PER CENT**

The Bank Canada raised the overnight rate by 50 bps to 1.0 per cent in 2017. With the economy on firmer footing, it looked to restore the policy rate back to levels prior to the oil-induced "emergency cuts" in 2015. While certain

indicators justify such a move — unemployment rate nearing cyclical lows and improving business confidence — there is still slack left in the economy. Inflation is subdued with core and headline readings well below the 2.0 per cent target at 1.4 and 1.5 per cent respectively. As the effects of transitory factors fade, such as subsidized electricity cost in Ontario, inflation should begin to gain traction. Along with the recent pickup in wage growth resulting from lower unemployment, the Bank of Canada expects headline inflation to be nearing 2.0 per cent in the second half of 2018.

**2.8 IMPROVING BUSINESS CONFIDENCE DRIVES EMPLOYMENT**



SOURCE: STATISTICS CANADA



Two St. Thomas, Toronto

### CANADIAN DOLLAR A KEY DRIVER OF EXPORTS

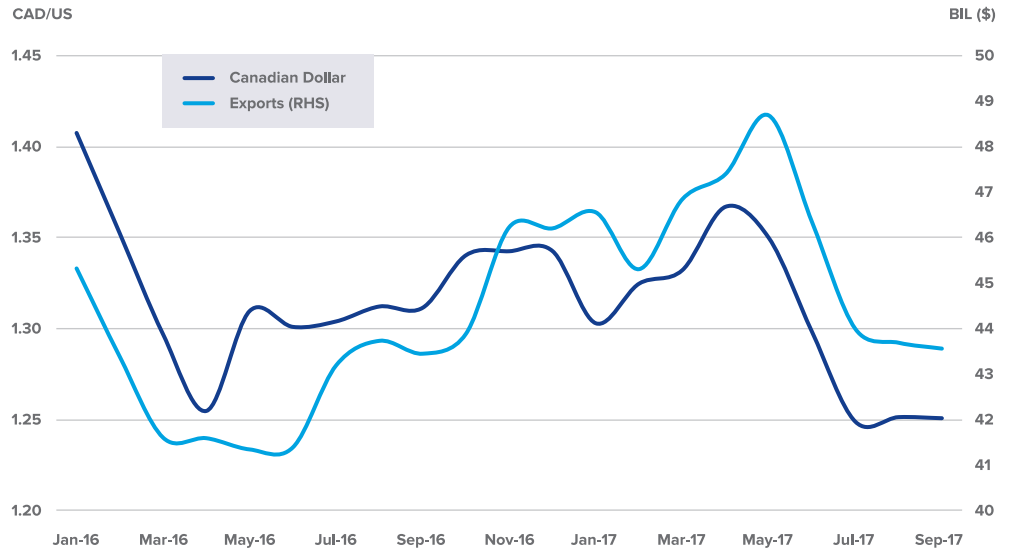
After re-establishing the overnight rate back to “normal” levels, the Bank of Canada is now likely to take a “wait and see” approach to further rate hikes, especially in absence of inflation pressure. In fact, the Bank of Canada has taken a less hawkish stance following the two rate hikes as it considers the myriad of downside risks that are currently present. It’s particularly mindful of the impact that an appreciating loonie can have on exports and manufacturing output — two primary channels of economic growth. This stance is of greater importance given that the trade environment has weakened noticeably over the past six months. Manufacturing output also slowed but is still higher on a year-over-year basis and is likely to regain ground with growth in new orders remaining healthy.

Given that export volume tracks very closely with the Canadian dollar and accounts for nearly one-third of GDP, the Bank of Canada could attempt to “talk down” the loonie with a more dovish tone to begin 2018 if it remains too elevated for comfort.

### NEW REGULATIONS COOL HOUSING MARKET

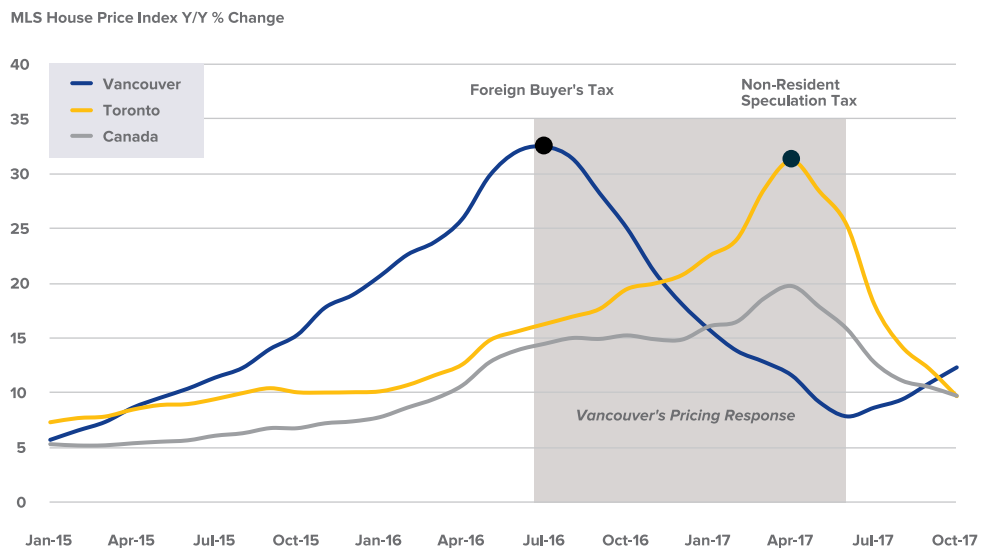
Conditions in an overheated housing market cooled, led by slowdowns in Vancouver and Toronto. Unsustainable price growth in these two markets prompted regulators to implement policy measures to discourage speculative investors. Following the foreign buyer’s tax in mid-2016, the price adjustment in Vancouver was short-lived, with the peak to trough range lasting approximately one year. This could be a reliable reference point in gauging the Toronto housing market’s response to the Non-Resident Speculation Tax that was introduced in April 2017. The fundamental drivers in these two markets are similar — strong economic and population growth, combined with supply constraints, leading to foreign and domestic speculation. The outlook for the Canadian housing market will be contingent on how conditions in the GTA continue to adjust to more stringent mortgage regulations and higher borrowing costs.

### 2.9 STRONGER LOONIE WEIGHS ON EXPORTS



SOURCE: STATISTICS CANADA

### 2.10 HOUSING MARKET RESPONDS SWIFTLY TO REGULATIONS



SOURCE: CREA





SUBWAY • SHOPPING CONCOURSE

# 32

NUMBER OF U.S. STATES WITH CANADA AS NUMBER ONE EXPORT MARKET; SOURCE: INTERNATIONAL TRADE ADMINISTRATION

## NAFTA RE-NEGOTIATION ADDS MORE UNCERTAINTY

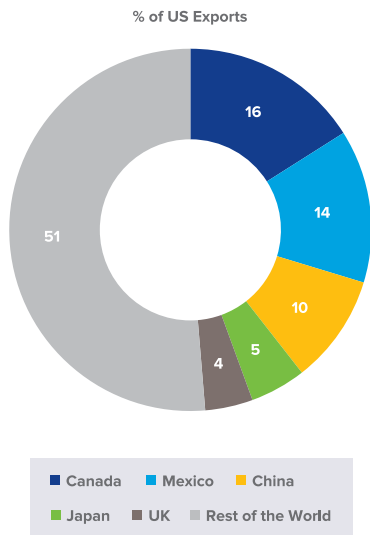
Tax reform in the U.S. poses a downside risk to competitiveness, creating uncertainty around business investment and trade in Canada. Meanwhile the impact of NAFTA's potential dissolution adds another element of risk. One main point of contention involves the "rules of origin," a provision dictating which goods move tariff-free across NAFTA member countries. This will be of great interest to Canada, as the majority of its commercial exports benefit from NAFTA tariff protection. In particular, the automotive

industry, Canada's largest manufacturing and export sector, is likely feel the brunt of any tightening of tariff rules.

It is also worth noting that Canada and Mexico are key destinations for U.S. goods, accounting for approximately 30 per cent of total U.S. global exports. Therefore, any unilateral outcome from the NAFTA renegotiations could result in reciprocal tariffs placed on outbound U.S. goods across North America. This would negatively impact the competitiveness of export-oriented sectors within the 32 states that currently have very strong trade ties with Canada. Due to this situation, any NAFTA dissolution proposed in Congress could be stalled as members are mindful of "not rocking the boat" with their constituents, especially with the House of Representative election coming up later in the year.

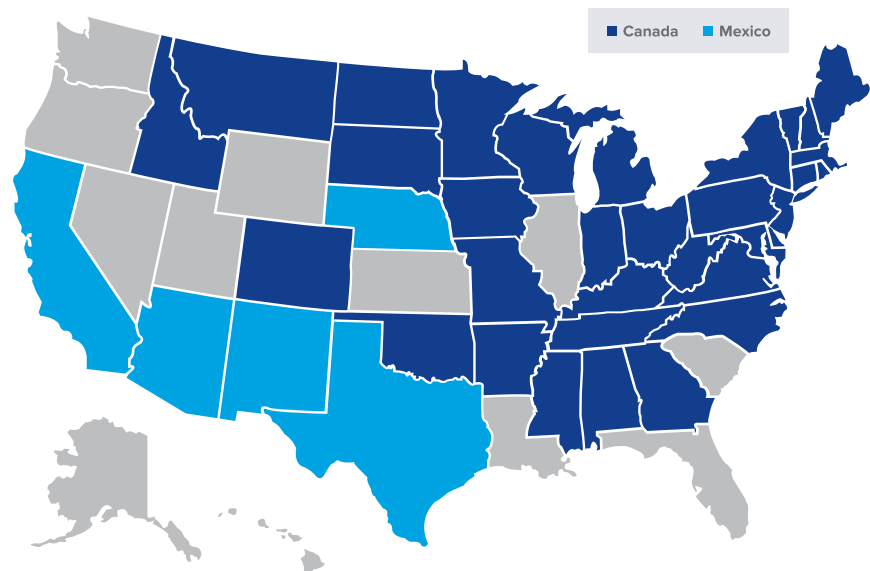
Canada and Mexico are key destinations for U.S. goods, accounting for approximately 30 per cent of total U.S. global exports

**2.11 CANADA AND MEXICO - KEY MARKETS FOR US EXPORTS**



SOURCE: BLOOMBERG; 2017

**2.12 U.S. STATES WITH CANADA AND MEXICO AS NUMBER ONE EXPORT PARTNER**



SOURCES: INTERNATIONAL TRADE ADMINISTRATION, BLOOMBERG, RBC ECONOMICS RESEARCH; 2017

# Real Estate and Capital Markets

- Canadian real estate continues to deliver steady income returns
- REITS with exposure to Alberta and/or retail have had a challenging year and rising interest rates may add to the headwinds
- Investment volume is on pace to surpass 2016's record \$34.7 billion with \$33.1 billion having transacted through three quarters
- Debt capital is anticipated to remain plentiful and favourably priced for borrowers with high quality assets, but expect lenders to be more selective with those of lesser quality and located in secondary markets
- Strong demand for real assets and healthy property fundamentals should help to preserve capital values, but challenged assets will be more vulnerable in a rising interest rate environment

# Capital Markets: Canadian real estate performance providing steady income returns



The REALPAC/IPD Canada Property Index for standing investments posted a 6.3 per cent total return for the four-quarter trailing period ending Q3 2017. Strong performance was a result of continued strength in the Vancouver and Toronto markets and more stable conditions in Alberta. Multi-residential and industrial continued to be the top performing sectors driven by strong capital appreciation. In this “late-cycle” environment, investors are focused on projecting income returns through prudent active management. This attention is crucial given

that income accounts for the majority of total returns and appreciation from cap rate compression is likely to be tamed going forward. While yields have compressed in recent years, the real estate asset class continues to generate an average 4.9 per cent income return, which remains attractive in this low interest rate environment. Investors can reasonably expect commercial real estate total returns to finish 2017 at an annualized rate of ~5.0-7.0 per cent with a similar outlook for 2018.

# 6.3%

CANADA DIRECT EQUITY REAL ESTATE TOTAL RETURNS FOR THE FOUR-QUARTER TRAILING PERIOD ENDING Q3 2017; SOURCE: MSCI REALPAC/IPD CANADA PROPERTY INDEX

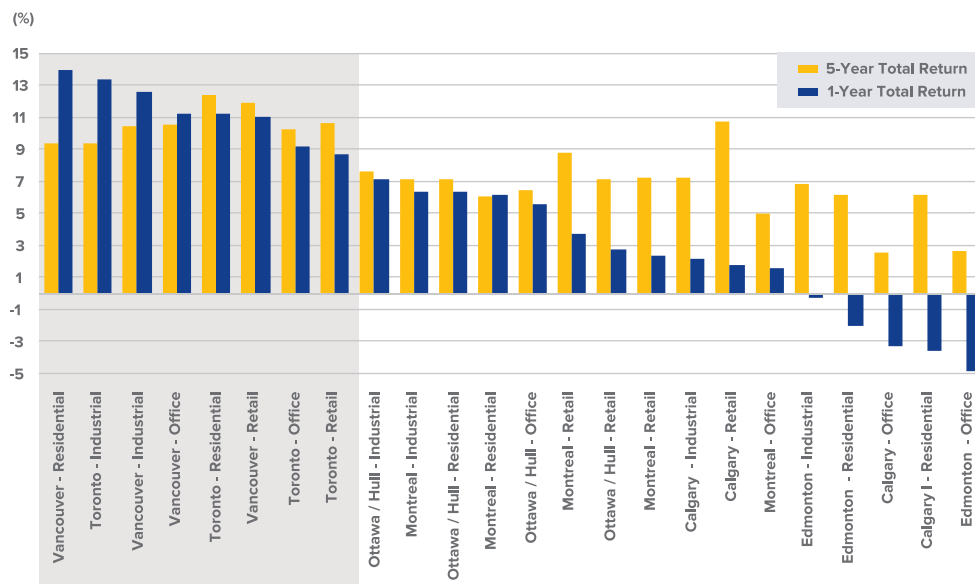
## U.S. REAL ESTATE OUTPERFORMS CANADA FOR A FOURTH YEAR IN A ROW

Looking south of the border, returns have moderated much in the same way as in Canada in recent years. The NCREIF Property Index (NPI) posted a 6.9 per cent return over the comparable four-quarter trailing period. While Canada outperformed the U.S. post-Global Financial Crisis, the U.S. real estate market has now outperformed Canada in each of the last four years. U.S. returns have been driven particularly by outperformance in the Pacific markets and in the industrial sector.

## CANADIAN REITS CHALLENGED BY EXPOSURE TO ALBERTA AND RETAIL HEADWINDS

After an impressive 17.6 per cent gain in 2016, the S&P TSX Capped REIT Index registered a modest 3.8 per cent total return through three quarters of 2017. The listed REIT sector was challenged in 2017 by headwinds in the retail and Alberta property sectors which penalized REITs overexposed in these areas. As a result, a number of asset sales in Alberta to rebalance portfolios have provided opportunities for inves-

### 3.1 VANCOUVER AND TORONTO DRIVING TOTAL RETURNS



SOURCE: MSCI REALPAC/IPD CANADA PROPERTY INDEX, Q3 2017

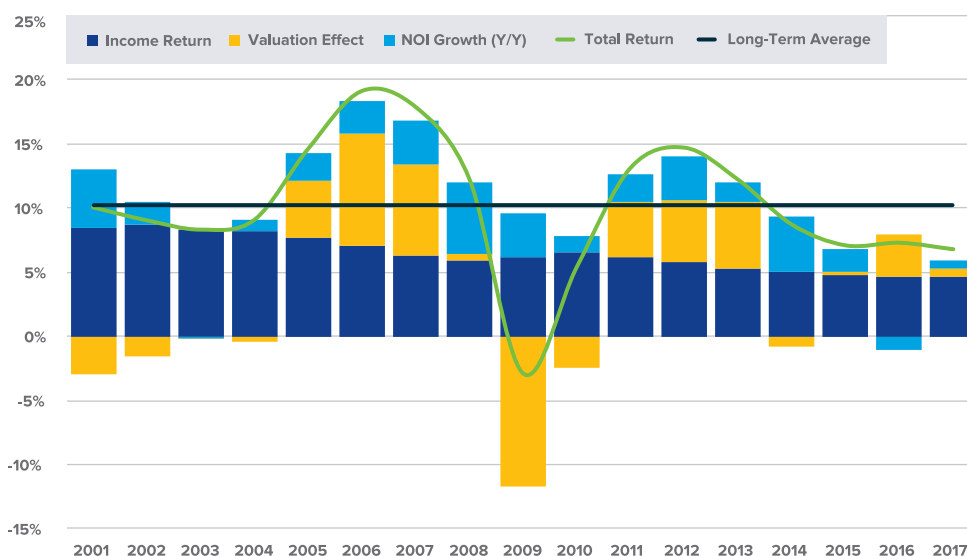
tors to acquire properties at very generous yield spreads in this market relative to the rest of the country. Expect more REITs to pursue disposition strategies of non-core holdings in 2018 to re-focus their business while attempting to crystallize gains and cull lower growth assets.

Meanwhile, despite strengthening economic fundamentals, the S&P/TSX Composite Total Return Index registered a modest 4.4 per cent return through three quarters of 2017, continuing to be bogged down by the energy and materials sectors which account for roughly a third of the index. Despite moderating returns, direct equity real estate continues to provide strong risk-adjusted returns relative to other asset classes.

“Returns in the year ahead will be largely income driven with capital appreciation coming from only those assets with strong prospects for future rent growth”

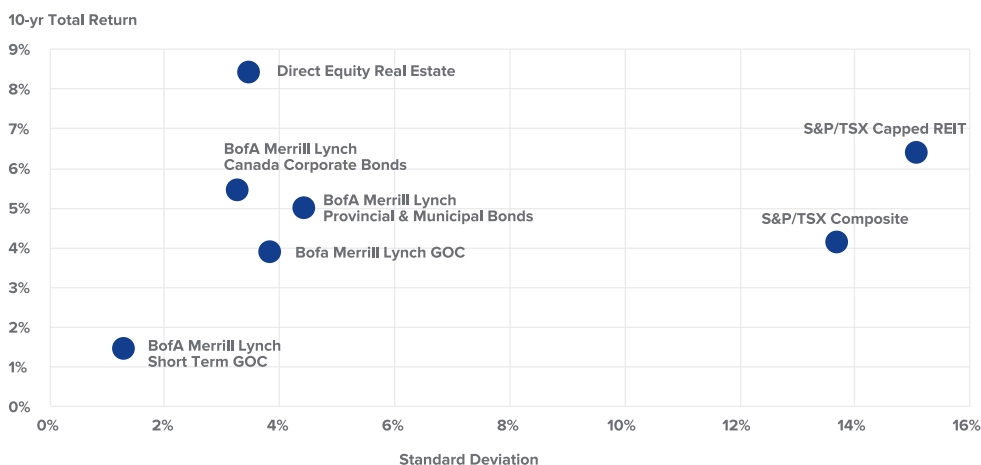
— DAVID LEVY, SENIOR VICE PRESIDENT, HEAD OF VALUATION

### 3.2 RETURNS MODERATING BUT CONTINUING TO GENERATE STABLE CASH FLOW



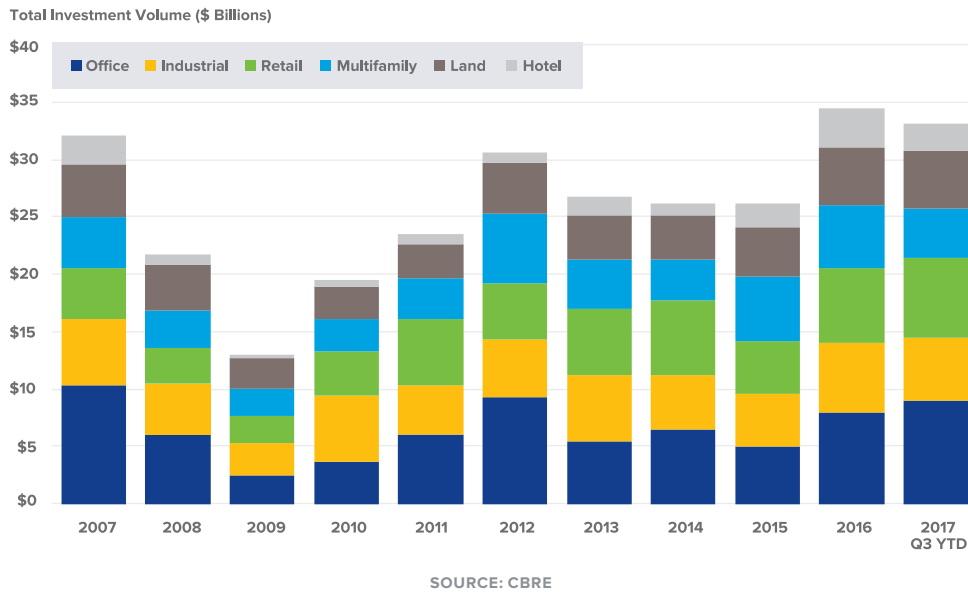
SOURCE: MSCI REALPAC/IPD CANADA PROPERTY INDEX

### 3.3 CANADIAN DIRECT EQUITY REAL ESTATE DELIVERING SOLID LONG-TERM RISK ADJUSTED RETURNS

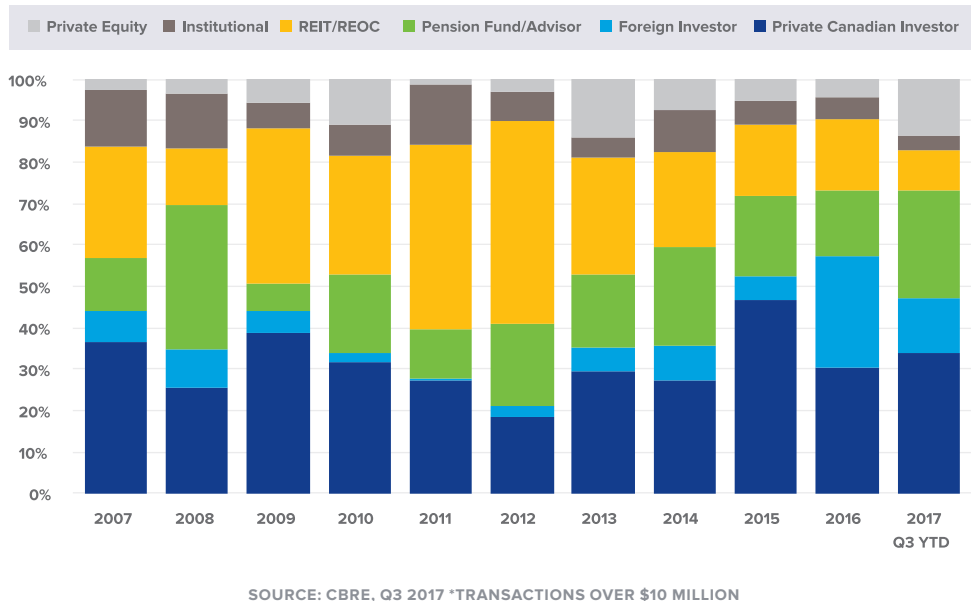


SOURCES: MSCI REALPAC/IPD CANADA PROPERTY INDEX, BLOOMBERG

### 3.4 CANADIAN INVESTMENT VOLUMES ON PACE FOR ANOTHER RECORD YEAR IN 2017



### 3.5 PRIVATE INVESTORS AND PENSION FUNDS MOST ACTIVE BUYERS IN 2017



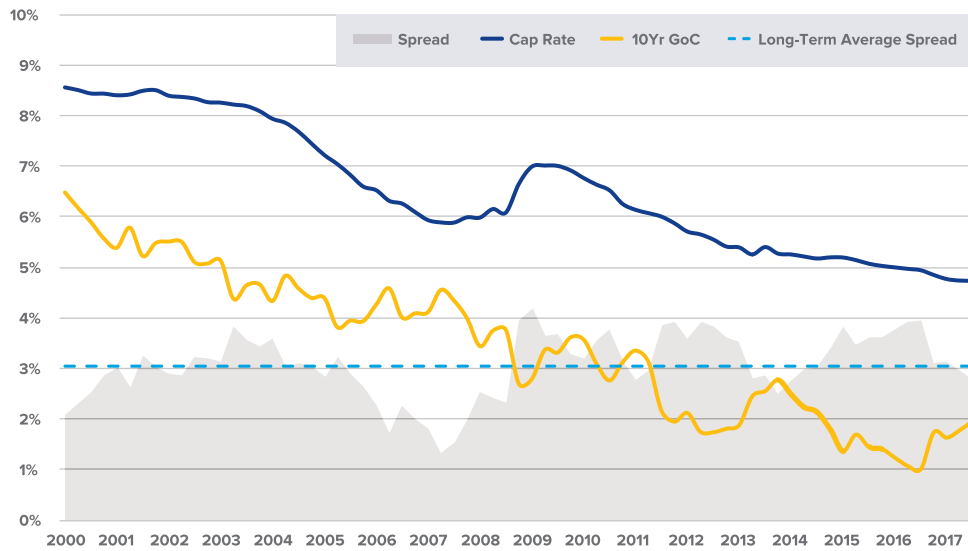
### INVESTMENT VOLUME ON PACE FOR ANOTHER RECORD YEAR

Total investment volume for the third quarter year-to-date was \$33.2 billion, well ahead of last year's record pace. With a number of noteworthy transactions expected to close by the end of the year, 2017 is certain to set a new high watermark. Once again, transactions have been broad-based with office and retail leading the way. Land has also garnered a lot of activity as investors have shifted more capital towards development, aiming to achieve higher returns compared to those of competitive priced income producing assets. Not surprisingly, 65 per cent of the transaction volume occurred in Toronto and Vancouver as both foreign and domestic investor demand remained robust for assets in these highly liquid markets with strong economic underpinnings.

The composition of buyers has shifted noticeably in the last few years. Pension fund/advisors, private equity and foreign investors have been significantly more active, while investment by REITS has fallen off due to their higher relative cost of capital. Foreign investors have provided a formidable force for trophy asset purchases but have more recently diversified their interest beyond downtown office buildings to a broader range of property types. China was the greatest source of cross-border capital in 2016; however, its tighter capital controls appear to have slowed the pace of investment in the latter half of 2017, lowering the foreign buyer contribution to the overall market to 14% at the end of the third quarter.

According to research conducted by RBC Capital Markets, as of year-end 2016, Canadian pension funds held aggregate property holdings of ~\$188 billion, representing a 12.9 per cent allocation to real property, which is up from just 6.6 per cent in 2014. RBC expects that real estate targets may reach 14-16 per cent over the next five years as alternative assets better match investors' yield and diversification requirements. This increased allocation is evident in the greater investment activity in Canadian real estate this year. However, Canadian pension fund capital is increasingly looking abroad, particularly to the U.S. where there is a greater breadth of opportunities with exposure to additional market segments.

### 3.6 CAP RATE SPREADS OVER RISK FREE NEAR LONG-TERM AVERAGE



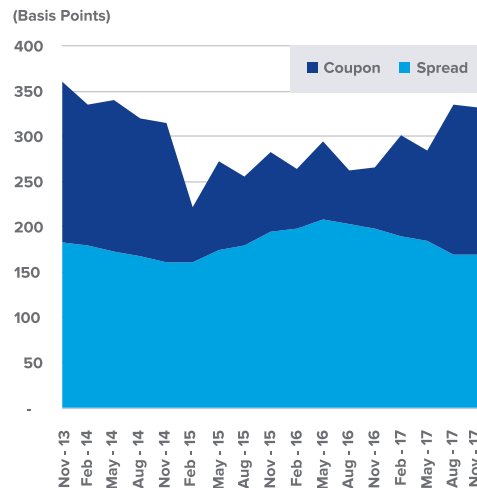
SOURCES: ALTUS, BANK OF CANADA, HAVER ANALYTICS

### REAL ESTATE DEBT MARKETS REMAIN BUOYANT

Debt capital continued to be readily available and competitively priced for high quality assets. As a result, real estate lending spreads for fixed term loans tightened 20-30 basis points over the course of the year (near five-year lows), but the all-in coupon climbed due to rising benchmark rates. For high-quality assets in major markets, CMLS, CBRE and our own research indicated that fixed rate spreads over risk-free rates are currently priced at 150-180 bps for five-year terms and 170-200bps for 10-year money. Underwriting standards tightened modestly throughout the year as lenders pulled back on loans with high loan-to-values (>75%) and increased their threshold for acceptable debt service coverage ratios. Additional prudence was exhibited for loans in secondary markets and class B assets, particularly for retail and suburban office properties.

Despite a more conservative approach, mortgage delinquency rates remain near historic lows at less than half a per cent. The conventional mortgage market remains attractive from a fixed income lender perspective, earning a healthy premium over BBB-rated unsecured corporate bonds. As such, the outlook for term financing in 2018 is quite bullish according to CBRE's 2017 Canadian Real Estate Lenders Report. One hundred per cent of survey respondents planned to either maintain or increase the size of their lending programs in 2018.

### 3.7 5-YR COMMERCIAL MORTGAGE SPREADS TIGHTENED IN 2017



SOURCES: CMLS, BANK OF CANADA

### 3.8 CONVENTIONAL MORTGAGE SPREADS OVER RISK-FREE RATES

5-YEAR TERM	150-180 BPS
10-YEAR TERM	170-200 BPS

SOURCES: CMLS, CBRE, BENTALL KENNEDY



Tour KPMG, Montreal

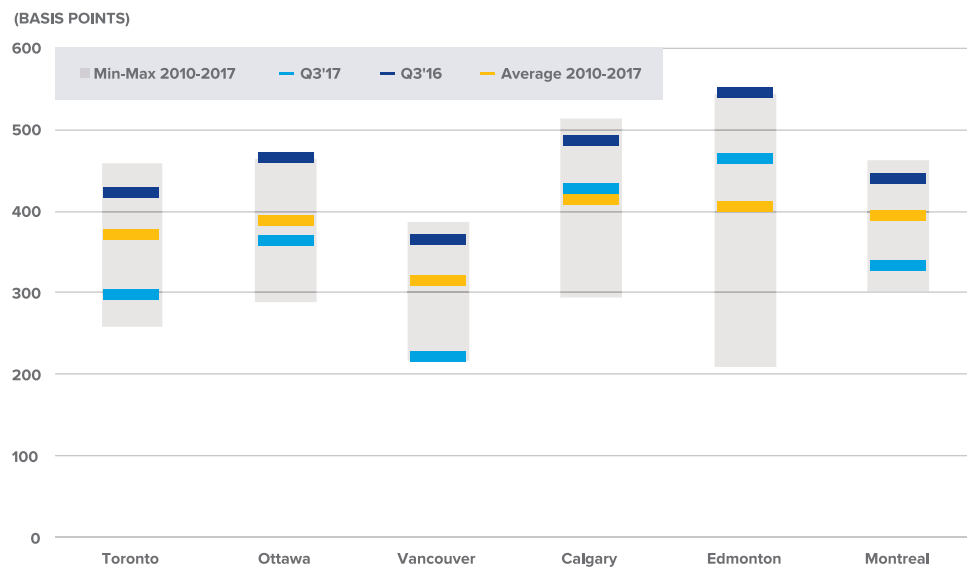


10  
DRIVER RD.

10  
DRIVER RD.



### 3.9 CAP RATE SPREADS OVER 10-YEAR GOC - DOWNTOWN OFFICE (ALL CLASSES)



SOURCE: MSCI REALPAC/IPD CANADA PROPERTY INDEX, Q3 2017

## Rising interest rates will erode valuations for assets that are in challenged markets or have idiosyncratic risks

Ninety per cent of those increasing their books, planned to do so by at least 10-30 per cent. Lenders expect increased competition, suggesting that pricing should remain attractive for borrowers. Not surprisingly, the vast majority of respondents expected mortgage spreads to move within +/- 10 basis point range in 2018. However, secondary market are expected to command an incremental risk premium of 10-20 basis points, while the same is true for class B assets as lenders move "up in quality" late in the cycle. Generally, strong mortgage performance and ample liquidity will help continue to "grease the wheels" in 2018.

### IMPACT OF RISING INTEREST RATES ON PROPERTY PERFORMANCE WILL VARY

One of the biggest questions for investors these days is to what extent higher interest rates will impact cap rates and property values. With an improving economic outlook, interest rates are on the rise, albeit at a modest pace. The Fed is anticipated to raise rates gradually through 2018 after its most recent hike in December. Meanwhile, the Bank of Canada is likely to take a more measured approach in the year ahead as it considers: the impacts of the two rate hikes in 2017 on consumption; a cooling housing market; and NAFTA renegotiations. Meanwhile, long-term interest rates have increase from their record bottom but remain historically low. The yield curve is flattening in both the U.S. and Canada, suggesting that growth and inflation expectations are still somewhat subdued. Global investors' search for yield in this low interest rate environment is also exerting downward pressure on bond yields. This phenomenon is exacerbated by aging demographics which is leading to a rebalancing of investment portfolios towards more income-oriented fixed-income instruments and lower risk profiles.

The impact of a rising interest rate environment on real estate performance is difficult to predict as cap rates are influenced by a number of variables including: the outlook for NOI growth

based on real estate fundamentals, capital flows, and investor appetite for risk. Cap rate spreads over risk-free rates are often used as a barometer of whether or not real estate is fairly priced. Spreads are now slightly below their long-term average but far from the tightness exhibited towards the end of the last cycle in 2007. There's an argument to be made that as the industry has matured a number of factors have contributed to a structural shift that has lowered the risk profile of commercial real estate in Canada, making comparisons to long-run averages less relevant. These factors include:

- Increased industry transparency
- Increased concentration of "institutional" ownership
- Greater sophistication and institutionalization of development
- Less leverage and more stringent underwriting discipline
- Greater portfolio allocations to real estate
- Increased global demand for yield

Property types, geographies and individual asset performance will all be impacted to varying degrees by rising interest rates depending on the health of the variables mentioned. For example, when looking at the downtown office markets across the country, cap rates spreads in Toronto and Vancouver have seen the greatest compression, but for good reason — strong liquidity and the prospects of future rent growth has attracted plenty of capital.

In addition, with a competitive lending environment anticipated to persist, lending spreads could compress further, softening the increase in coupon rates and cost of capital. Combined with a healthy availability of debt financing, this should mitigate increases in cap rates due to base rate expansion. However, rising interest rates will erode property values located in challenged markets or those with idiosyncratic risks, such as weak tenant credit or unfavourable lease expiry profiles.



One York Street,  
Toronto

# Property Sectors

# 04

## Office

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Strong labour market underpinning steady demand in markets outside of Alberta

- Expanding tech sector drives downtown office demand in major urban markets
- Tight conditions in downtown Vancouver and Toronto resulting in a lack of quality space
- Suburban absorption gaining momentum from strong job creation and tenants priced out of downtown
- Occupancy per office worker steadily declining due to evolving workplace strategies
- As cap rate compression moderates, NOI growth is anticipated to be the main driver of capital appreciation in 2018



**Bentall  
Kennedy**

# Office: Toronto and Vancouver outperform

# 4.3%

ANNUAL RATE OF TECH EMPLOYMENT GROWTH SINCE 2011; SOURCE: CBRE, STATISTICS CANADA

Office employment growth has been robust in most major markets outside of Alberta. This demand has bifurcated the trajectory of the national office market. Excluding Alberta, class A vacancy decreased 130 bps Y/Y to 5.4% driving upward pressure on rents. Meanwhile, Calgary and Edmonton are experiencing near record vacancy levels and there are few signs of any new sources of organic tenant demand. The outlook for the energy sector is tentative, but crude oil prices have stabilized and could see moderate gains in 2018 as global economic growth improves. As the Alberta economy continues to recover, office fundamentals in Calgary should improve but balanced market conditions are still a long way off.

## TECH SECTOR DRIVES OFFICE USING EMPLOYMENT

Key sectors within the office using employment base continue to register healthy gains. Although employment growth within the FIRE and public sectors levelled off in recent quarters, both are up on a year-over-year basis and have posted consistent gains since 2015. Despite tepid conditions in the housing market weighing on the financial services sector, FIRE employment managed to add 39,000 jobs over the past 12 months and grew by 3.4 per cent (y/y) as of September 2017.

The tech sector is one of Canada's fastest growing industries and is playing a crucial role in driving office employment. Tech employment has increased by an annual rate of 4.3 per cent since 2011 and this growth appears to be biased regionally, as Vancouver, Toronto and Montreal are seeing the majority of this rapid expansion. All are attractive markets for tech firms looking to gain access to the sizable pool of high-skilled

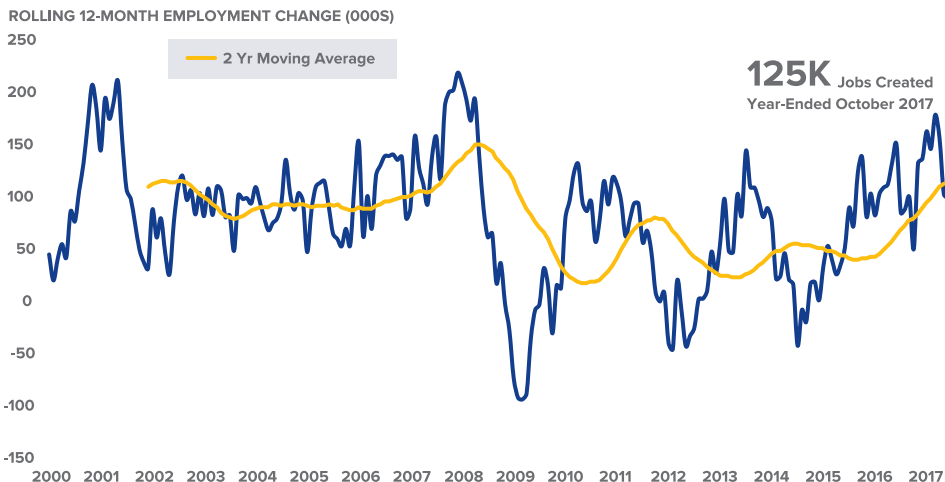
workers that tend to reside in large metro areas with world class universities.

As the Canadian economy aspires to be less dependent on commodity-driven growth, high-value sectors should garner more support from governments through incentive-based policies aimed at encouraging innovation. An open immigration policy should also help to facilitate further advancement as it shores up high-skilled talent from abroad. The private sector is responding to these mandates with capital investments in emerging innovation industries such as artificial intelligence in tech-heavy markets such as Montreal and Toronto. This trend is still in its infancy, but it does speak to the growth momentum of the tech sector and the potential impact that it can have on the office market.

“Tech tenants who have outgrown their brick and beam space are opting for traditional glass buildings—providing opportunities to design innovative new developments and to renovate well-located older class A stock”

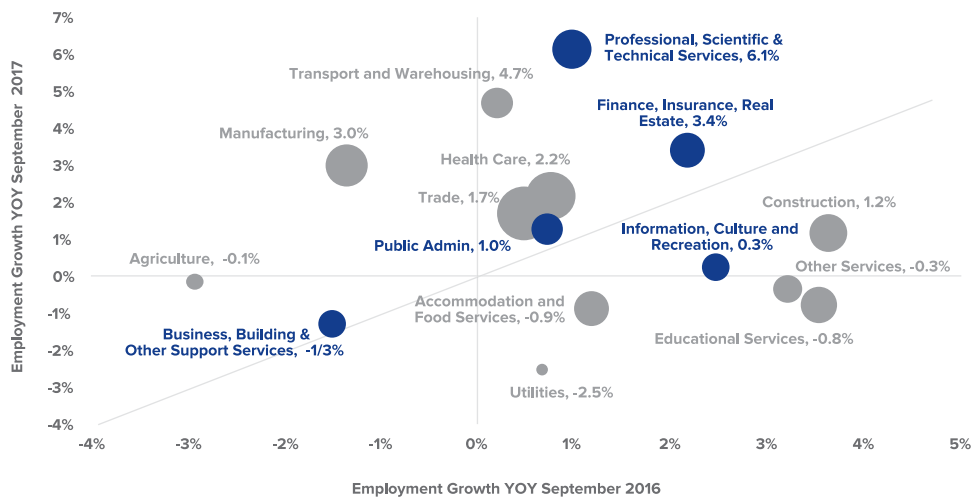
—MARK RZADKI, VICE PRESIDENT, OFFICE LEASING

### 4.1 OFFICE USING EMPLOYMENT GROWTH ACCELERATING



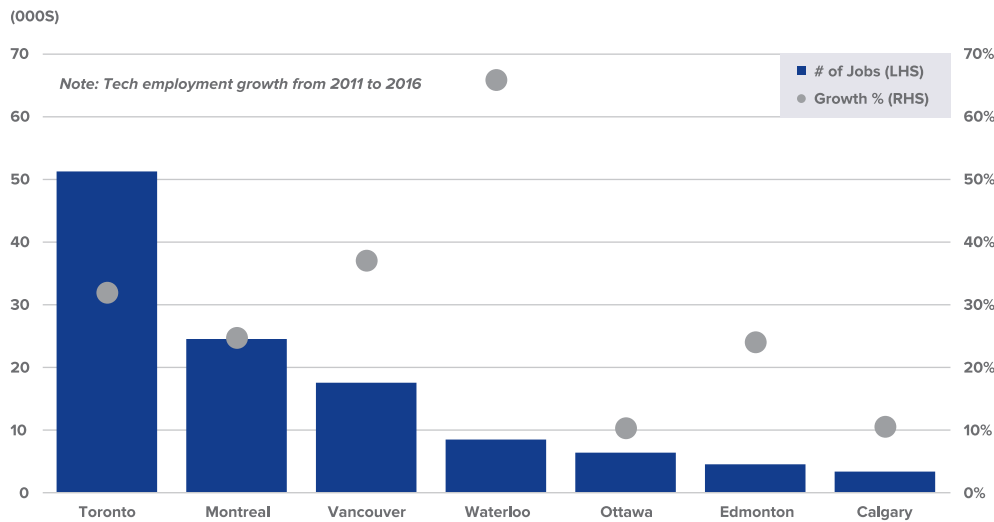
SOURCE: STATISTICS CANADA

### 4.2 EMPLOYMENT GROWTH BY SECTOR



SOURCES: STATISTICS CANADA, HAVER ANALYTICS

### 4.3 TECH EMPLOYMENT BASE EXPANDING AT AN IMPRESSIVE RATE

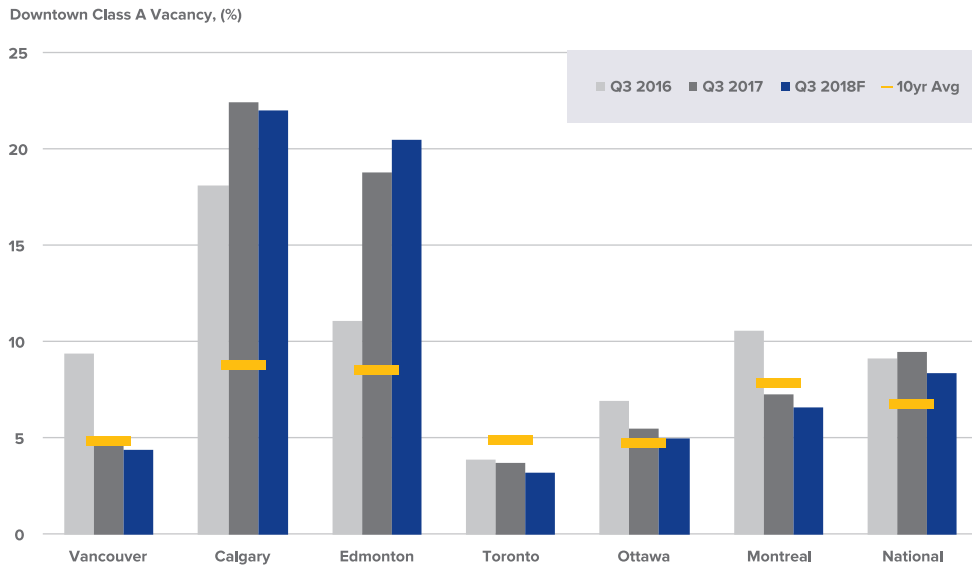


SOURCES: CBRE, STATISTICS CANADA



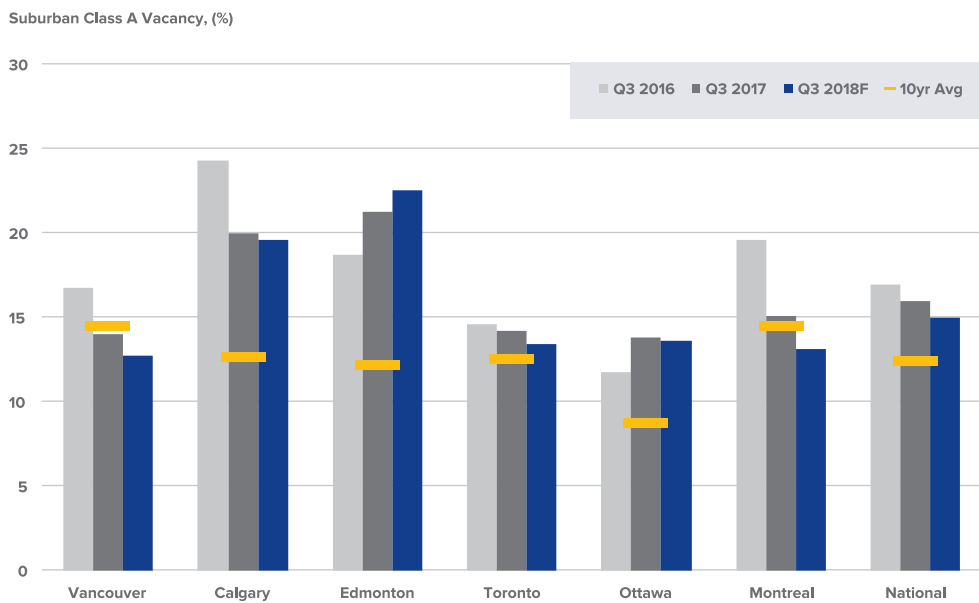
150 King Street West, Toronto

#### 4.4 VANCOUVER AND TORONTO AMONG TIGHTEST DOWNTOWN MARKETS IN NORTH AMERICA

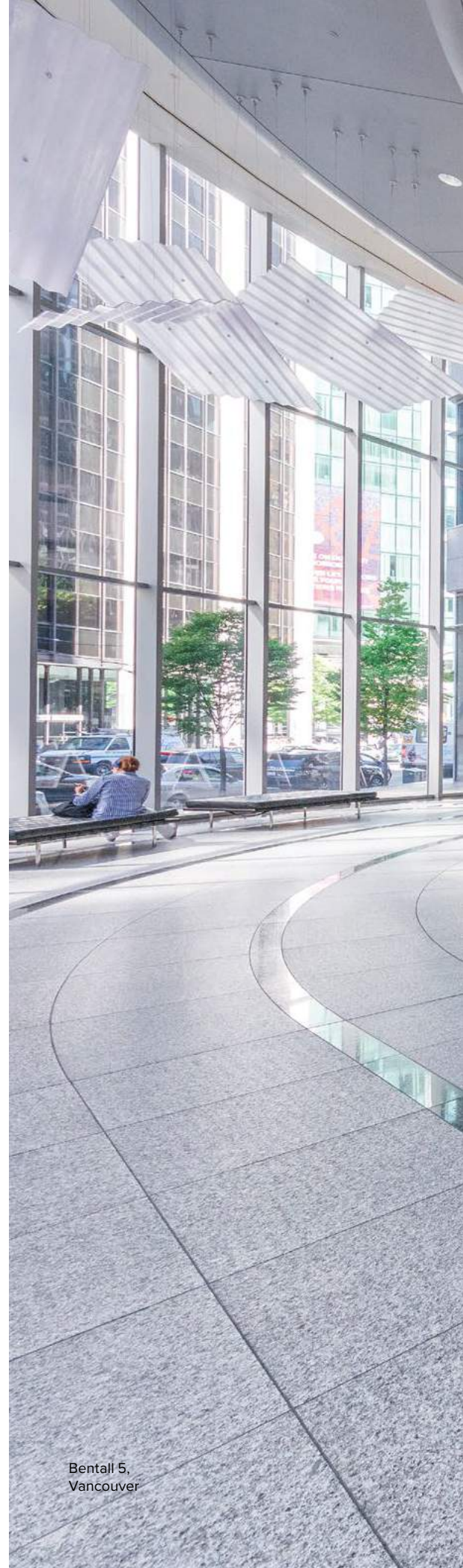


SOURCES: CBRE, BENTALL KENNEDY

#### 4.5 SUBURBAN FUNDAMENTALS IMPROVING IN MOST MARKETS



SOURCES: CBRE, BENTALL KENNEDY



Bentall 5,  
Vancouver



### TIGHT CONDITIONS IN DOWNTOWN VANCOUVER AND TORONTO

Despite 3.3 million sf of new supply since 2016 Q1, Toronto's downtown office market continues to see class A vacancy compress further below its long-term trend. At 3.7 per cent, the class A vacancy rate in downtown Toronto is among the lowest in North America. With a growing appetite for space, the tech tenant base has been very active on the leasing front, contributing to much of the current tightness. A lack of availability and rising rents downtown are encouraging some mid-size tech tenants to look to peripheral submarkets. Especially nodes with sufficient critical mass and transit access such as the downtown West are garnering more attention from prospective tenants. Although there is close to 4.0 million sf currently under construction in Toronto, and a further 14.0 million sf in the planning stage, upward pressure on rents is anticipated to persist in the short term as there is no material supply relief until 2020.

Conditions are equally tight in downtown Vancouver. Unlike Toronto, this market has not seen as much new supply and the current development pipeline is at least a year away from providing any new space. Tenants are having an even greater challenge securing quality space, especially ones with ambitious

growth plans. Of note is Amazon's recent absorption of a sizable block of space from We-Work — making it the largest single occupier of office space in the city. Mid-sized tenants are finding themselves “crowded out” by the online retail giant. Developers are looking to capitalize on these bullish conditions with 3.1 million sf of new construction planned for downtown Vancouver over the next few years.

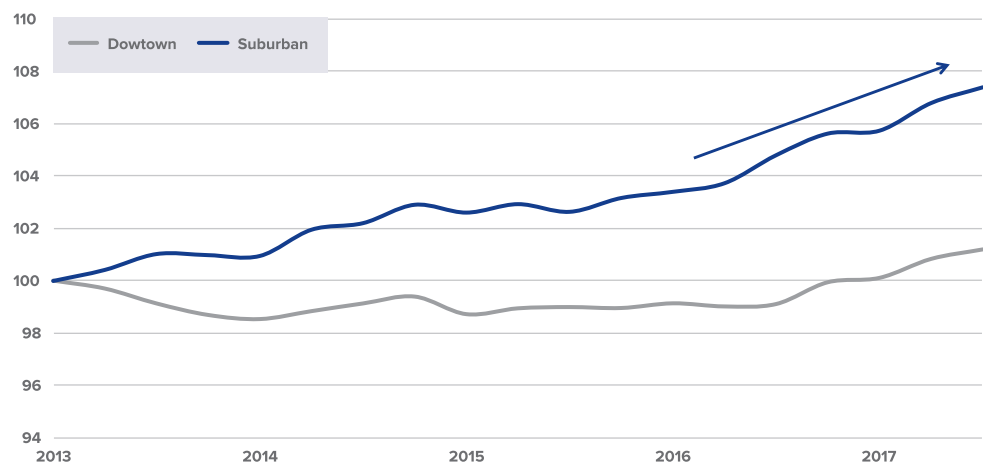
### OCCUPANCY GROWTH PICKING UP IN THE SUBURBS

Suburban occupancy growth has gained momentum over the past eight quarters and has been outpacing its downtown counterpart. The extent in which this trend is evident depends on the quality of space and location. In particular, assets with superior transit access, ample parking and abundant surrounding retail amenities are attracting the most interest.

In Vancouver, the lack of availability in the downtown core is shifting demand into the suburbs, where leasing options are more affordable and plentiful. Suburban class A vacancy fell by 270 bps y/y to 14.0 per cent in Q3 2017 with much of the leasing activity taking place in nearby Broadway, Richmond and Burnaby. With no new supply scheduled to come online in downtown Vancouver in 2018, these tran-

### 4.6 SUBURBAN DEMAND OUTPERFORMING DOWNTOWN

Index: 2013 Q1 = 100



SOURCE: CBRE

sit-oriented suburban nodes should remain in high demand. Suburban Toronto is also experiencing this spillover in excess demand, albeit to a lesser degree. These conditions should continue to bode well for the North submarket where the new TTC extension makes it a feasible option for some downtown tenants.

Montreal's suburban office market is also performing well as class A vacancy fell by 450 bps y/y to 15.1 per cent in Q3 2017. Solid employment growth, particularly in the aforementioned tech sector, is driving leasing activity in non-core submarkets such as Midtown and Laval where rental rates are more affordable. Year-to-date suburban absorption as of Q3 2017 is a whopping 1.1 million sf, which is poised to surpass the one-million-sf mark for the first time on record in 2017.

**EVOLUTION OF WORKPLACE STRATEGIES**

Despite steady office employment growth, occupancy per office worker is declining. This trend reflects desire to reduce costs and an increased focus on "how space is being utilized" rather than "how much." For many companies that want to maintain long-term competitiveness, corporate real estate is not just an input cost but a means to attract talent and enhance productivity by focusing on the health and wellness of workers. Tenants are allocating more resources to better quality space that is amenity-rich and provides for flexible work environments. Workplace strategies are continually evolving and each industry is handling office space a little differently depending on the nature of work. Generally, more traditional industries such as energy, law and government are reducing space while tech and creative industries are expanding their footprint. Regardless, an office location within close proximity to residential, transit and retail amenities is critical in attracting the next generation of workers, especially as millennials are projected to make up 50 per cent of the labour market by 2020.

**RETURNS MODERATING AND SUPPORTED BY CAP RATE COMPRESSION OUTSIDE OF ALBERTA**

Office returns increased marginally to 7.1 per cent in the four quarters trailing to Q3 2017, 20 bps higher than the 6.9 per cent recorded in the same period in 2016. Income returns averaged a healthy 5.1 per cent, while cap rate compression was offset by declining NOI due to weak conditions Alberta.

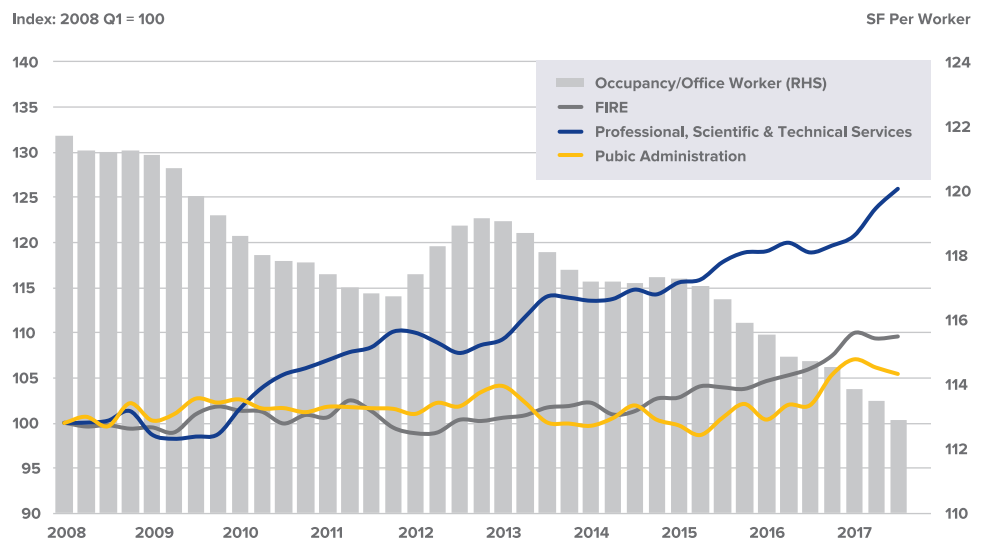
Toronto and Vancouver continued to provide the best returns for investors, especially downtown where capital appreciation was driven by cap rate compression and NOI growth. With downtown cap rates for institutional quality assets currently at historical lows (below 5%), the onus will be on NOI growth to drive returns in these two markets going forward.

50%

SHARE OF MILLENIALS IN LABOUR MARKET BY 2020; SOURCE: CBRE

Competitive pricing in Toronto and Vancouver has increased investor interest in other markets in Canada, such as Montreal, where "going-in yields are higher and property fundamentals are improving. A number of benchmark transactions occurred in these markets and will likely result in upward repricing of comparable assets and should drive returns in the fourth quarter. In contrast, risk premiums have increased notably in Calgary and Edmonton for assets that aren't leased to long-term to tenants with investment grade credit. A number of assets that are currently being marketed in Alberta will provide further price discovery should they transact in 2018.

**4.7 OCCUPANCY PER WORKER STEADILY DECLINING**



SOURCES: CBRE; STATISTICS CANADA



# Property Sectors

# Q4

# Retail



Headwinds cloud the outlook for retail performance but headlines overblown

- Pace of change accelerates — retailers can ill afford to take a “wait and see” approach
- Strongest year for core retail sales growth since 2006 — expect a more cautious consumer in the year ahead
- Slowing mall productivity reflects secular headwinds — landlords need to deliver compelling reasons to visit the mall
- Ecommerce still in its infancy in Canada but growing rapidly - expect further disruption and bifurcation between retailers that can deliver and those that fail to adapt
- Active investing in retail has never been more critical



# Retail: How do retailers remain relevant?

The world of retail continued to evolve in 2017 and the pace of change is accelerating as we head into a new year. There was no shortage of ominous headlines, especially amongst U.S. department store retailers who occupy a strong presence in enclosed malls. However, the Canadian retail landscape is more sanguine but not without its own challenges, which are starting to become more evident.

## STRONGEST RETAIL SALES GROWTH SINCE 2006

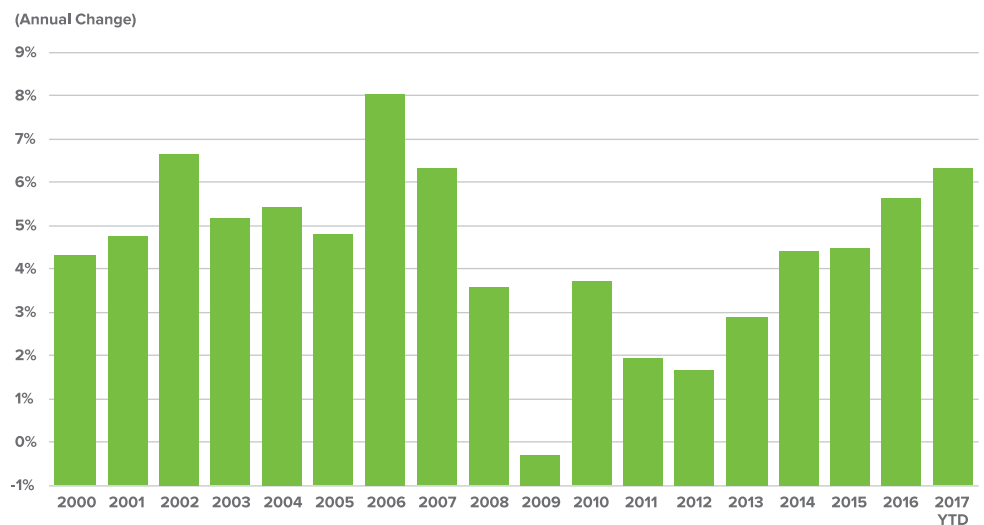
From a macro viewpoint, core retail sales were exceptionally healthy, registering 6.3 per cent growth YTD through September — on pace for the strongest growth since 2006. Impressive sales were underpinned by a strong labour market and a weaker Canadian dollar, which discouraged shopping south of the border and attracted plenty of tourism spending. However, the cyclical tailwinds that have supported consumer spending are beginning to fade and retail sales have decreased for the third month in a row through September, after removing price effects.

A slowdown in the housing market is beginning to make households more cautious and consumers could also be taking a “breather” after four strong years of consumption. Elevated debt levels and rising interest rates are expected to slow discretionary spending as households focus on “normalizing” their balance sheets. Fortunately, the recent momentum in wage growth should help mitigate some of these headwinds and help sustain a more moderate pace of retail sales growth.

## MALL PRODUCTIVITY GROWTH MODERATING

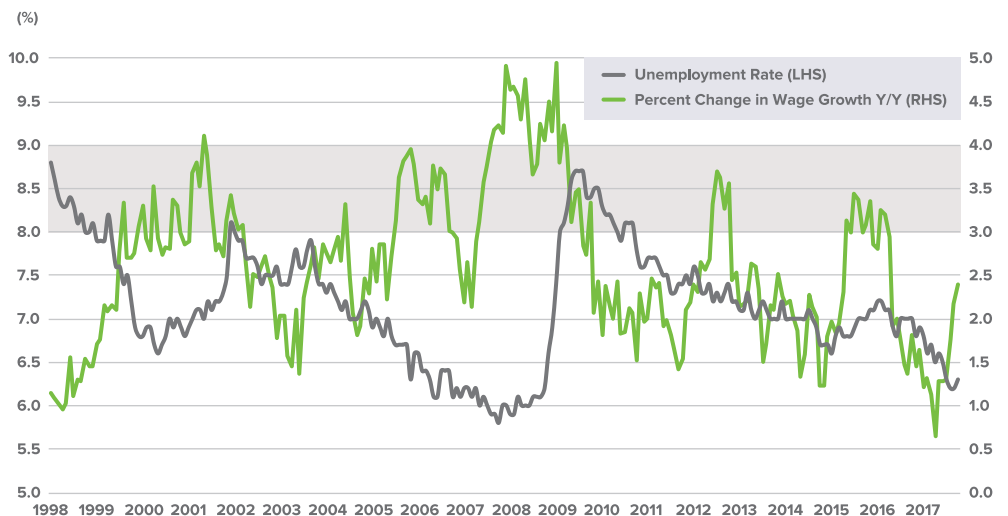
A gap has emerged between retail sales and mall productivity growth, suggesting that secular headwinds are starting to negatively impact enclosed shopping centres in Canada. Increases in mall productivity growth have been positive over the last two years but have lagged core

**4.8 CORE RETAIL SALES GROWTH HAS BEEN ON A STEADY CLIMB OVER THE PAST FIVE YEARS**



SOURCE: STATISTICS CANADA

**4.9 WAGE GROWTH ACCELERATING BUT STILL SLUGGISH GIVEN THE TIGHT LABOUR MARKET**



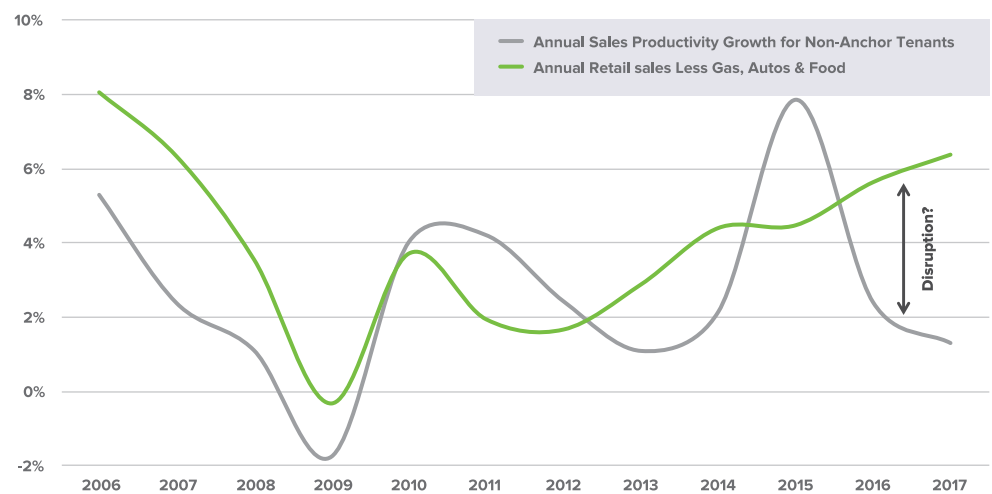
SOURCE: STATISTICS CANADA

“Enclosed malls are facing mounting headwinds so it’s incumbent upon landlords to collaborate with retailers to create environments where they can surprise and delight shoppers—giving them a reason to come to the mall”

—PHIL STONE,  
VICE PRESIDENT, HEAD OF  
CANADIAN RESEARCH

retail sales growth figure. This suggests that ecommerce, aging demographics and changing consumer preferences are displacing sales. Additionally, mall sales productivity amongst the top 20 malls has slowed even further than the headline figures this year, suggesting secular headwinds may be more entrenched and far reaching than previously thought.

#### 4.10 RETAIL HEADWINDS DISRUPTING ENCLOSED MALL SALES PRODUCTIVITY GROWTH



SOURCE: ICSC - NON-ANCHOR RETAIL SALES OF 92 CENTRES ACROSS CANADA, MOST OF WHICH ARE REGIONAL AND SUPER-REGIONAL MALLS WHICH INCLUDE MORE THAN \$16.0 BILLION IN 2016

#### 4.11 PERSISTENT HEADWINDS



SECULAR

CHANGING CONSUMER PREFERENCES  
ACCELERATION OF ECOMMERCE  
AGING DEMOGRAPHICS



STRUCTURAL

OVER-RETAILED IN SELECT SECTORS/GEOGRAPHIES  
DEPARTMENT STORE OBSOLESCENCE  
LACK OF CRU TENANT DEPTH  
CONCENTRATION OF WINNERS  
OVER LEVERAGED RETAILERS  
NAFTA UNCERTAINTY  
MINIMUM WAGE INCREASE



CYCLICAL

HIGHER INTEREST RATES  
HIGH CONSUMER DEBT LEVELS  
COOLING HOUSING MARKET  
SLOW WAGE GROWTH  
HIGHER CAD\$

SOURCE: BENTALL KENNEDY



Edmonton Brewery District,  
Edmonton

## ECOMMERCE STILL IN ITS INFANCY

This shift in consumption patterns is evident in the ~18 per cent year-over-year growth in online sales. Ecommerce penetration rates remain relatively low in Canada (2.4 per cent of retail sales, Statistics Canada) from a global perspective compared to 10 per cent in France, 14 per cent in the U.S., 15 per cent in Germany and 18 per cent in the UK. However, at this brisk pace of online growth, that gap is expected to close in the years ahead as retailers work to deliver a frictionless shopping experience across channels.

The ability of retailers to evolve to changing consumer preferences will be critical. Two of the biggest Canadian examples of a “failure to adapt” were the demise of Target Canada and most recently, Sears. Although the latter has been expected for some time, it adds another ~15 million sf of vacancy to the ~6 million square feet of former Target space yet to be re-absorbed. Like the Target fallout, landlords of the top-tier Sears locations will have no trouble re-leasing the space and in many cases at accretive net effective rents. However, it will be the secondary markets with weak surrounding demographics that will have difficulty backfilling the vacancy, resulting in obsolete space that may require major capital investment to reposition the asset.

## GROCERY GOES DIGITAL

Once thought to be immune to the shifting retail landscape, grocery-anchored retail is appearing to be more vulnerable. While still one of the more defensive bets, Amazon’s acquisition of Whole Foods sent shock waves through the industry. Canadian grocers have taken notice and are not waiting to see how it plays out. A look at recent headlines indicates that Loblaw, Metro and Sobeys will all be active this year in making significant investments in home delivery:

- Sobeys to lay off more than 800 office employees in cost-cutting effort ahead of broader investments in operation and ecommerce
- Loblaw to lay off 500 office staff to cut costs, close 22 stores and to begin home delivery in Toronto and Vancouver
- Metro expanding ecommerce delivery beyond Quebec

Other Canadian retailers should also take note of these incumbents’ digital strategies — for it will be the banner that can move the customer

#### 4.12 CANADIAN ECOMMERCE LAGGING MOST OF THE DEVELOPED WORLD



SOURCES: STATISTICS CANADA, GREEN STREET ADVISORS

Redirecting shoppers online will help grocers to better understand their customers, enabling them to curate engaging shopping experiences

#### A PIVOTAL YEAR IN RETAIL TECH

Whether its chatbots, online shopping algorithms, face recognition technology or ad targeting — it’s all being made more effective through artificial intelligence. This year provided two major technological advancements in Canada with retail applications that are sure to impact consumer behaviour. The first is the rise of virtual assistants, notably — the launch of Amazon’s Alexa Voice Service into Canadian households. While still far from mass adoption, the use of digital assists is growing rapidly. There are many ‘skills’ developable for voice-controlled speakers, but perhaps the most profound is the ability to shop online using voice commands. These devices are certain to be a disrupter when it comes to the low-value, household commodity purchases that most consumers care little to spend time on — think dishwasher detergent, milk, shampoo. Amazon is inverting the retail model by integrating the point of sale into the lives of consumers. It’s the “stickiness” of Amazon’s platform that worries retailers as they are able to capture an increasing share of consumers’ wallets across multiple categories.

The second is the ARKit that Apple introduced in its latest iOS 11 software update which enables the iPhone with augmented reality. Ikea, Target and Wayfair have all incorporated this functionality into their apps this year. The Ikea Place app lets you select a new sofa and view it in your living room, on your screen, as if it were right in front

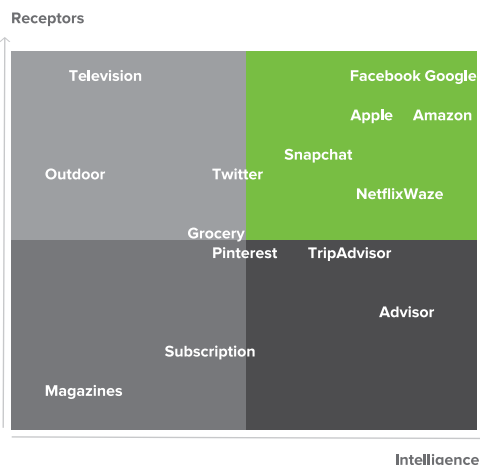
to their online platform first that will have the upper-hand when it comes to customer retention — regardless of whether the sale occurs online or offline. Customer acquisition and brand loyalty are incredibly important when looking at the transformative demographic shifts occurring:

- Leading edge of the baby boomers just turned 70 and they’re less likely to want to/nor able to lug home the centre grocery store aisles
- The bulge in the 20-35 age cohorts are entering their higher household goods consumption years — many of these households contain dual-income, full-time wage earners and simply don’t have the time to spend in-store

While delivering groceries to the home would appear to be a loss-leader, redirecting shoppers online will help grocers to better understand their customers, enabling them to curate engaging shopping experiences. NYU Stern professor Scott Galloway describes the new “algorithm of value” as the ability of companies to use “receptors” (in this case — data collected from online shopping orders and movement in-store) and “intelligence” (innovative use of

that data) to enhance the end-user experience. Whoever is able to put the best-quality food on the dinner table, with the least amount of effort required of customers, at the most affordable price will have a huge competitive advantage going forward.

#### 4.13 THE NEW ALGORITHM OF VALUE



SOURCE: L2 INC

of you. Home furnishings and appliances are new use cases for the technology but nearly every major beauty brand is now using realistic AR try-on technology. Developed by ModiFace, the technology enables women to sample shades of lipstick or eye lashes to instantly see how each one looks on their face, mixing and match styles and colours as often as they want. It's easy to imagine how this technology could be extended to fashion and other retail categories.

**WHO'S GETTING DIGITAL RIGHT?**

Retailers successfully navigating this new digital economy are able to seamlessly engage consumers across multiple channels and technologies, meaning:

- SITE & E-COMMERCE
- DIGITAL MARKETING
- SOCIAL MEDIA
- MOBILE & TABLET

And more important than ever, the in-store experience — as the “physical store is becoming a marketing function not a sales function”. Doug Stephens, a prominent retail strategist — put it eloquently when he wrote, “... in a world of fleeting and fragmented attention, shopping spaces are an opportunity for shoppers to be fully (cognitively, emotionally and physically) engaged in a branded media experience that no other media format can consistently promise.” Successful retailers will continue to rightsize and rationalize their real estate while leveraging their stores to engage customers with their brand.

**ACTIVE INVESTING HAS NEVER BEEN MORE CRITICAL**

As a result of the disruption in retail, particularly in secondary and tertiary markets, landlords can no longer afford to be passive investors. This means proactively reinventing and reconfiguring shopping centres to include experiential uses (food, restaurants and entertainment) and/or non-retail (residential, office/medical or fulfilment) uses to keep the space relevant. It

**4.14 LOWER OCCUPANCY MANIFESTS IN TOTAL RETURNS**



SOURCE: MSCI REALPAC/IPD CANADA PROPERTY INDEX

also means improving the community programming and working collaboratively with retailers to provide a compelling reason to visit a mall. Simply put, if the shopping centre is not the best game in town, it's going to face an inordinate number of challenges in the years ahead. These headwinds will ultimately weigh on investment returns if not proactively managed.

**IMPLICATIONS FOR PROPERTY FUNDAMENTALS AND RETURNS**

The extent to which this rapidly changing retail environment is impacting fundamentals depends on the type of shopping centre. Investment returns have been moderating more for enclosed malls and community shopping centre formats than other asset classes when comparing one-year returns against three and five-year returns. Neighbourhood centres remain the one bright spot and continue to be the more defensive play — but as we note, the grocery segment is ripe for disruption.

There is little doubt that the shopping experience will look markedly different in ten years' time. Being invested in long duration assets, it will be critical for managers to stay abreast of the evolving trends and adjust their strategy appropriately. One of the biggest challenges and opportunities will be engaging the millennial demographic as they move into their higher consumption years combined with the greater purchasing power that will result from a transformative generational wealth transfer. The ability to capitalize on these trends will be the key to generating excess returns.

# Property Sectors

# 04

# Industrial

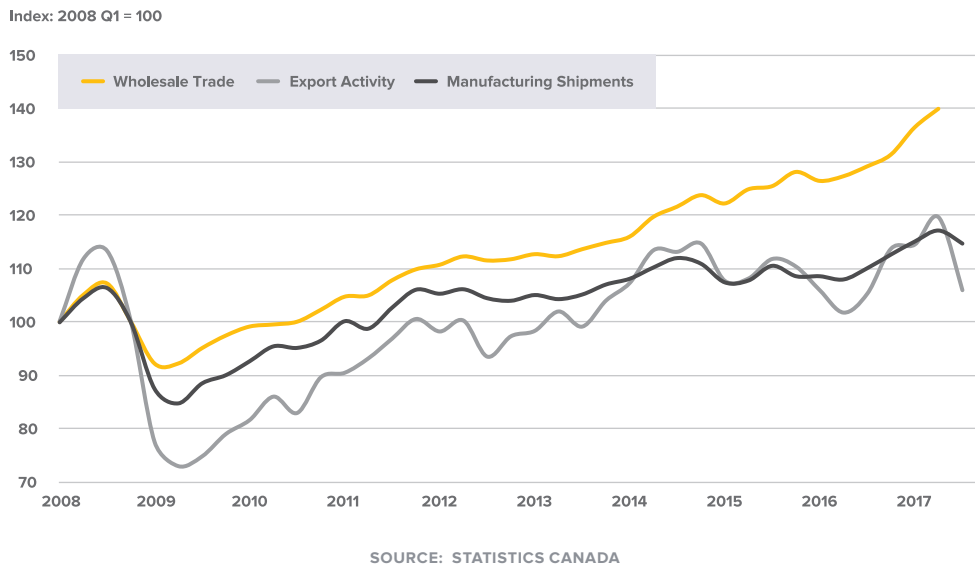


Macro fundamentals are supportive of continued rent growth

- Distribution and manufacturing activity — core drivers of industrial demand
- Vancouver and Toronto are two of the tightest industrial markets in North America - Calgary making positive strides
- Healthy rental growth driving speculative development
- Ecommerce and technological innovation impacting the demand and utilization of industrial space

# Industrial: Availability at 15-year low

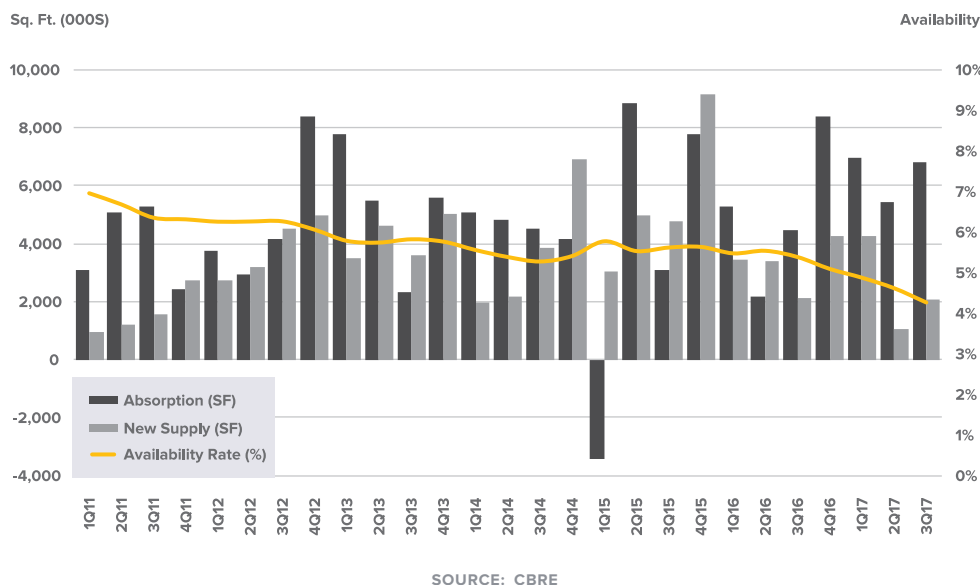
## 4.15 WHOLESALE TRADE DRIVES DISTRIBUTION ACTIVITY



The industrial market is largely dependent on the production and logistics of non-commodity goods. On that front, the current macro environment has been very supportive of the goods-producing side of the economy, and by extension industrial demand. The national availability rate fell to a 15-year low of 4.3 per cent but as with the office asset class, performance was bifurcated between Alberta and the rest of the country. Buoyed by healthy consumer spending, wholesale trade has been a key driver of distribution and this sector should continue to benefit from the penetration of ecommerce.

That said, potential headwinds could take some steam out of the industrial market in 2018. While export and manufacturing activity are also driving demand for space, they have slowed of late. Due to its strong negative correlation with an appreciating loonie, as highlighted in the Canadian Economy section, export volume has softened and could weaken further if the Canadian dollar gains in value. Moreover, the uncertain outcome of NAFTA could cause some manufacturing tenants to take a “wait and see” approach which could weigh on their willingness lease space in the near term.

## 4.16 INDUSTRIAL MARKET CONTINUES TO OUTPERFORM



## CENTRAL CANADA BENEFITING FROM CURRENT ENVIRONMENT

As Canada’s largest regional economy, the GTA is not only a huge exporter of industrial goods, it is also an attractive market for retailers looking to expand their supply chains. This is evident by Amazon’s establishment of several fulfilment centres across the GTA over recent years, which has benefitted the demand for distribution-oriented space. Third-party logistics providers are also key players as they look to service mid-sized retailers looking to remain competitive with a greater online presence.

Consequently, conditions are very tight in the GTA and availability is now at a record low 2.3 per cent. The West submarket is where the majority of the leasing and development activity are taking place. This submarket should continue to garner a lot of interest from tenants and



# 4.3%

CURRENT AVAILABILITY RATE  
AT 15-YEAR LOW; SOURCE: CBRE

investors due to its close proximity to the U.S. border, superior access to transit infrastructure and an abundance of developable land.

Impressive economic growth and a revitalized manufacturing sector are having a positive impact on Montreal's industrial market. The availability rate registered its sharpest decline among the major cities over the past year and is currently at 6.2 per cent, the lowest level since 2002 Q2. Demand in this market is dictated by the lack of quality leasing options and increasing appetite for higher clear height space (24' and above). Under these conditions, landlords currently have more negotiating power to push for rental growth and should continue to do so until development activity picks up.

### VANCOUVER NOW RIVALS TORONTO

This preference for newer generation space is also very evident in Vancouver, another market that Amazon has been pursuing. Industrial space with higher clear height suited for logistics is in very short supply and availability is currently at 2.6 per cent, making Vancouver one of the tightest industrial markets in North America. Although approximately 2.6 million sf is scheduled to come online in 2018, conditions should remain fairly tight in Vancouver as the majority of this space has been committed in advance.

### OUTLOOK FOR CALGARY IMPROVES

Calgary's industrial market had a very strong showing in 2017 with demand coming from both large and mid-bay tenants. Calgary serves as a distribution hub connecting Western and Central Canada and as a result industrial fundamentals are not as exposed to the energy sector. In line with a rebounding local economy, demand should continue to benefit from manufacturing and retail driven logistics activity.

This improved outlook is reaffirmed by the fact that institutional investors appear to be less risk adverse when it comes to Calgary and are beginning to allocate capital back into this market, especially through speculative development. The most notable being Bentall Kennedy's 418,000-sf High Plains Industrial Park devel-

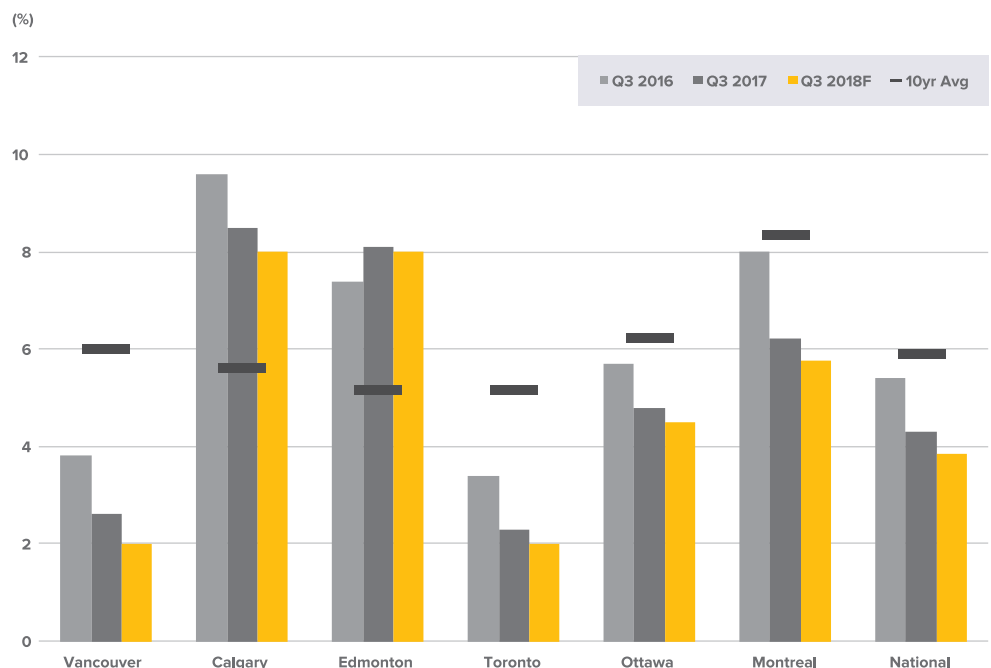
opment, the first project of this size since the plunge in oil prices in 2014.

### HEALTHY RENTAL GROWTH ACROSS MOST MARKETS

As expected, industrial net rental rates are experiencing solid gains, growing by 7.1 per cent (y/y) to \$6.93 PSF as of Q3 2017. Much of this net rental growth took place in large manufacturing and distribution hubs such as Vancouver, Toronto, and Montreal where net rents increased by 8.5, 9.0 and 5.3 per cent respectively. Meanwhile, Ottawa's small but stable industrial market saw net rents rise by 1.5 per cent. Consistent with a much improved economic outlook,

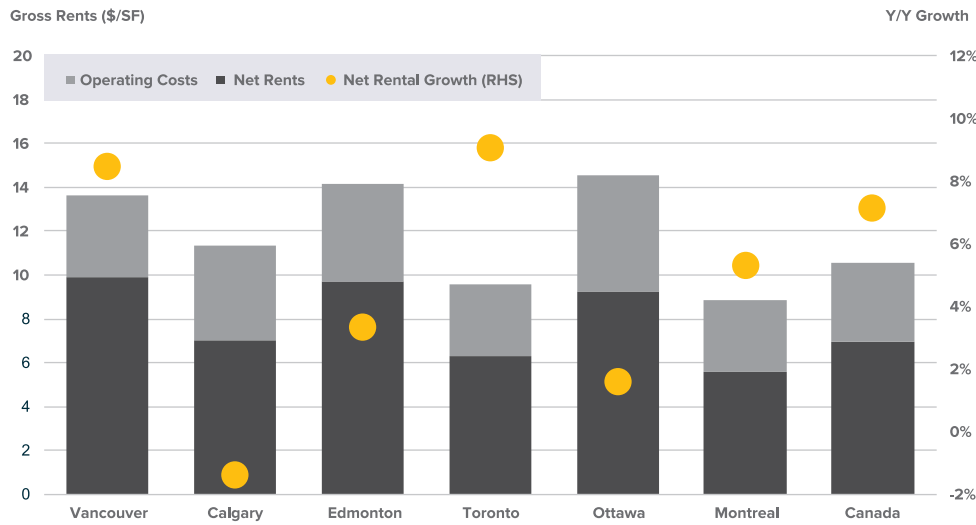
Conditions are tight and vacancy is near-zero in most markets for newer warehouses with modern design and functionality

### 4.17 AVAILABILITY TIGHTENS IN MOST MAJOR MARKETS



SOURCES: CBRE, BENTALL KENNEDY

#### 4.18 STRONG DEMAND FUNDAMENTALS DRIVE RENTAL GROWTH



SOURCE: CBRE

Traditional retailers have historically relied on a tiered distribution framework consisting of regional fulfilment centres and local warehouses serving as key transfer points within the supply chain. While this was adequate in servicing the needs of brick-and-mortar retailers, for which inventory levels are refilled at longer lead times, it is no longer efficient in the current omnichannel retail landscape.

This need for a more nimble and expansive supply network has been a driving force behind the demand for large-format industrial space. However, as the core components of their distribution channels become more integrated, some retailers are beginning to focus more attention on “the last mile” in large metro areas. As online retailers look to close the gap between the consumers and goods, demand for older space within close proximity to urban centres could improve.

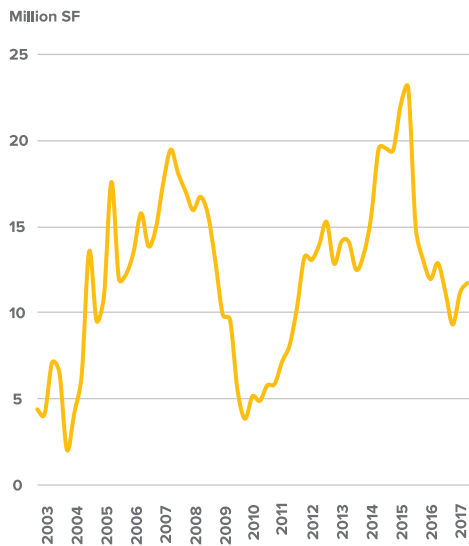
#### TECHNOLOGICAL INNOVATION ENHANCES CUBE UTILIZATION

Technological innovation is playing an important role in accommodating the growing need for businesses to improve distribution efficiency and delivery costs. Advancements in robotics and automation are enabling tenants to achieve better “cube utilization” — a measure of space usage, both vertically and horizontally. This increase in density is changing industrial space design and placing a greater emphasis on certain features such as higher clear heights, enhanced load-bearing capacity for material handling equipment and more parking spaces. Developers will not only have to adapt to the higher construction costs associated with this shift in tenant requirements, they are also having to contend with higher land values in major markets. However, more efficient space utilization could allow developers to mitigate some of these costs by building vertically on less land while providing the same amount of functional space.

#### HIGHER YIELDS AND NOI GROWTH DRIVE TOTAL RETURNS

Industrial was one of the top performing asset classes in 2017 with total return registering at 6.9 per cent in the four quarters to 2017 Q3. Strong demand fundamentals should continue to generate healthy NOI growth, and together with comparatively higher yields (5.2 percent) the outlook for industrial remains attractive.

#### 4.19 CONSTRUCTION VOLUME DOWN FROM 2015 PEAK



SOURCE: CBRE

net rental rates in Calgary have stabilized at around \$7.02 PSF after sharply falling in 2015.

The Edmonton industrial market finally showed life in the third quarter, pushing net rental rates to \$9.70 PSF — a 3.3-per-cent growth year-over-year. A significant portion of Edmonton’s manufacturing sector services the nearby oil-patch and this strong showing in the latter half of 2017 could indicate that conditions in the energy sector are beginning to improve.

#### DEVELOPMENT ACTIVITY POISED TO PICK UP

There is approximately 12 million sf under construction, well below the previous cycle peak of 24 million sf in mid-2015. With growing demand for high-quality industrial space, construction activity is poised to pick up in 2018 and 2019. Toronto and Vancouver should continue to see the lion’s share of speculative development as investors look to capitalize on historically tight conditions and impressive rental growth. Meanwhile, with more affordable land costs compared to Vancouver and Toronto, Montreal is an increasingly attractive market for developers as well.

#### ECOMMERCE AND “THE LAST MILE”

The rise of ecommerce has not only impacted the way in which brick-and-mortar retailers operate, it is altering the logistics of consumer goods.

# Property Sectors

# Q4

# Multi- Residential



Remains best bet for the year ahead

- A strong economy, population growth and deteriorating home ownership affordability should continue to drive positive absorption
- Despite elevated levels of construction, there are no signs of overbuilding
- Don't expect affordability to ease for renters in 2018 as suitable apartments will be harder to find and rents should continue to rise
- Multi-residential returns are expected to perform well but expect more modest capital appreciation driven solely by NOI growth

# Multi-Residential: Drivers of renter formation are intensifying

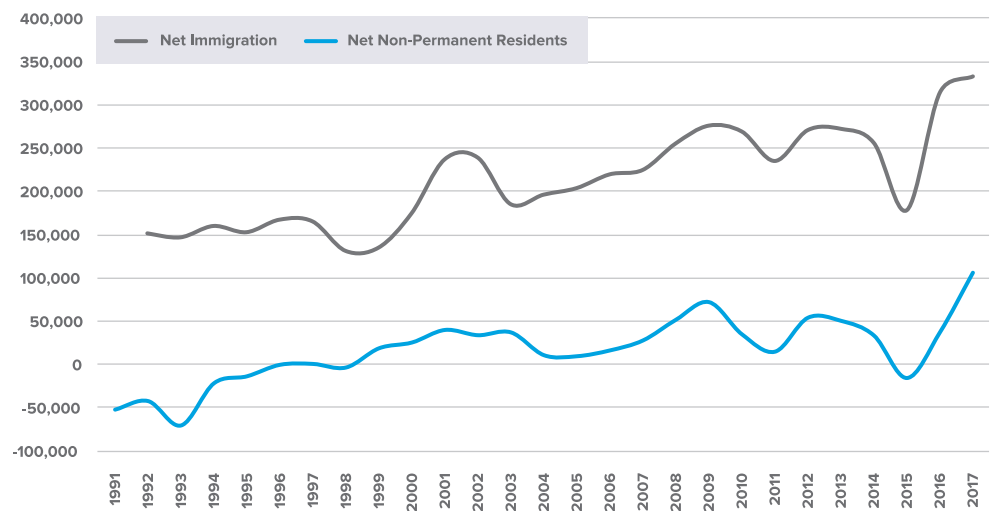
In an effort to help alleviate some of the long term challenges posed by the country's aging population and low birth rate, the federal government announced further increases to immigration targets in November. Ontario (and the GTA specifically) will continue to be the primary beneficiary, attracting a sizable portion of the new immigrants relocating to Canada. In addition, Ontario is experiencing a recent surge in both net interprovincial migration and net non-permanent residents due to attractive educational and employment opportunities. These trends will undoubtedly have a positive impact on apartment demand as newcomers tend to have a greater propensity to rent.

## AFFORDABILITY STRETCHED

Underpinning solid population growth is the improved strength of the economy, especially in the gateway cities of Toronto, Vancouver and Montreal where labour market conditions are robust. However, even with an improved financial situation, home ownership remains elusive for many as a result of the extreme lack of affordability in Vancouver and Toronto. Affordability is less of a concern in other parts of the country, but with interest rates rising, more Canadian cit-

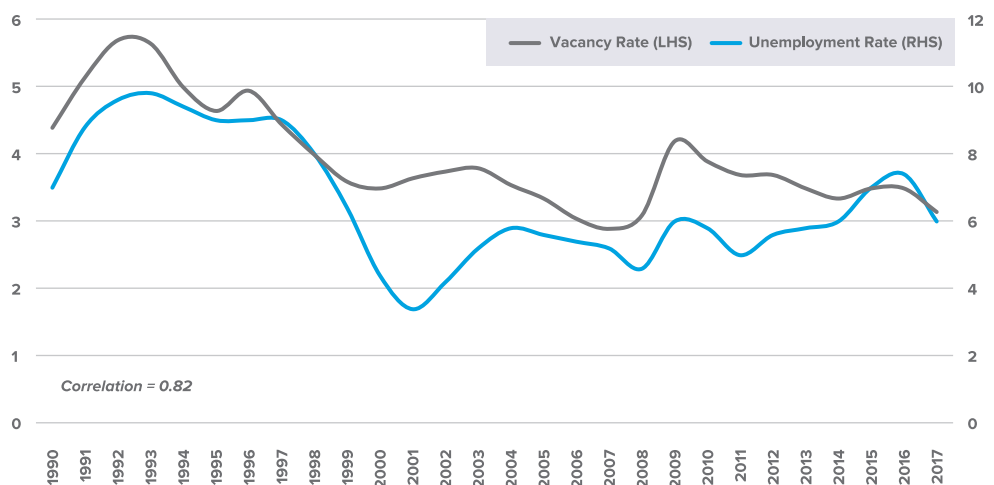
Ontario is experiencing a recent surge in both net interprovincial migration and net non-permanent residents due to attractive educational and employment opportunities.

**4.20 SURGE IN NATIONAL NET IMMIGRATION AND NET NON-PERMANENT RESIDENTS CREATES RENTAL DEMAND**



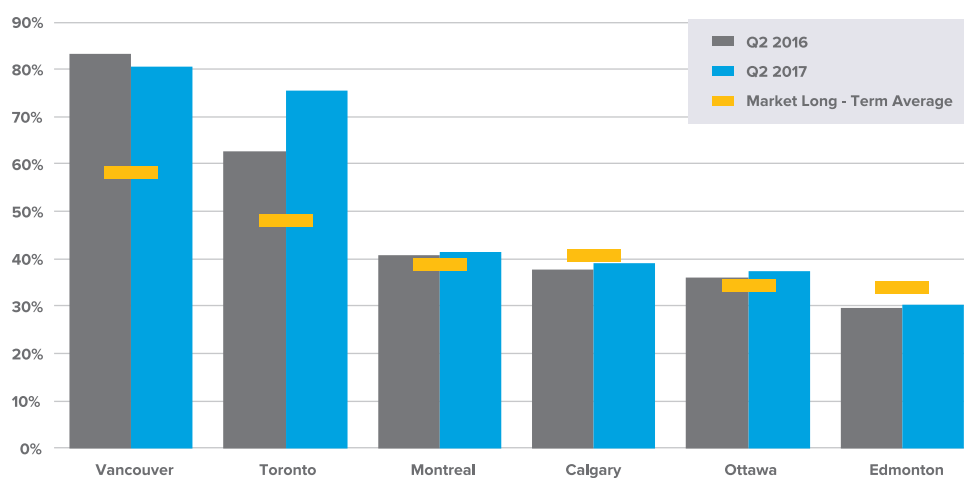
SOURCE: STATISTICS CANADA

**4.21 APARTMENT VACANCY IS HIGHLY CORRELATED WITH UNEMPLOYMENT**



SOURCES: CMHC, STATISTICS CANADA, HAVER ANALYTICS

#### 4.22 AFFORDABILITY STRETCHED IN VANCOUVER AND TORONTO (HOME OWNERSHIP COSTS AS A PERCENTAGE OF MEDIAN HOUSEHOLD INCOME)



SOURCE: RBC ECONOMICS RESEARCH

ies could begin to experience similar challenges. Furthermore, more stringent qualification rules being introduced by OSFI in January 2018 are likely to have a dampening effect on home prices as it erodes a buyer's purchasing power. An average priced Canadian home (\$500,000) will require an additional \$16,000 of annual income (an 18 per cent increase) to qualify for an uninsured mortgage under the new rules.

According to RBC Economics Research, Canadian housing affordability in the second quarter of 2017 eroded for an 8th consecutive quarter to reach its worst level since 1990. Vancouver's home ownership costs as a percentage of median household income (80.7 per cent) are on the rise again and approaching the record level reached in 2016. Meanwhile, the same measure in Toronto reached 75.4 per cent — up more than 1200 bps Y/Y and well above its long-term average, surpassing the previous record set back in the early 90s. Bottom line — declining housing affordability bodes well for rental demand as the economics for the average wage earner in Toronto and Vancouver make home ownership unattainable.

#### HOME OWNERSHIP RATES IN DECLINE

Low interest rates, access to housing credit and stable increases in property values provided tailwinds for home ownership in recent history. However, data from the 2016 census indicates that for the first time in decades, home ownership rates are on the decline across most major markets — the lowest level nationally since 2001. The decline is most pronounced across those under 35 years of age — prime renter cohorts.

#### RENT CONTROL'S UNINTENDED CONSEQUENCES

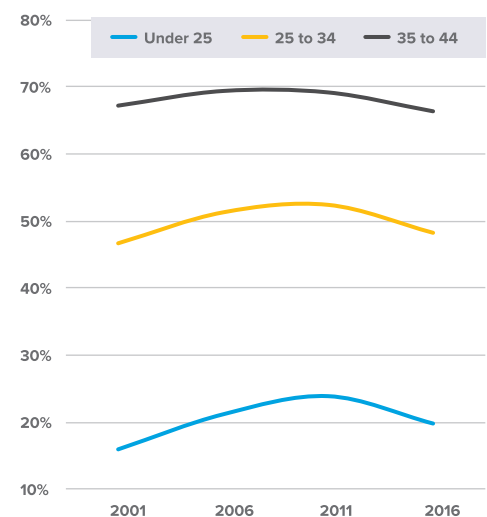
New rent control measures introduced by the Ontario provincial government in April aimed at improving rental affordability are certain to have unintended consequences. Capping annual rent increases at inflation is good for those tenants who are already renting and content on remaining in their location indefinitely — namely voting seniors. However, it leaves more mobile renters and first-time renters out in the cold, as apartment turnover rates are likely to decline. Lower turnover leaves fewer options for renters, which

in turn creates upward pressure on market rents. In addition, rent controls are a disincentive for new construction and makes bidding for purpose-built rental development land increasingly challenging as condo developers are able to pay more for development sites without controls on the sales price of new condos.

#### NEW SUPPLY INSUFFICIENT TO MEET RENTER HOUSEHOLD FORMATION

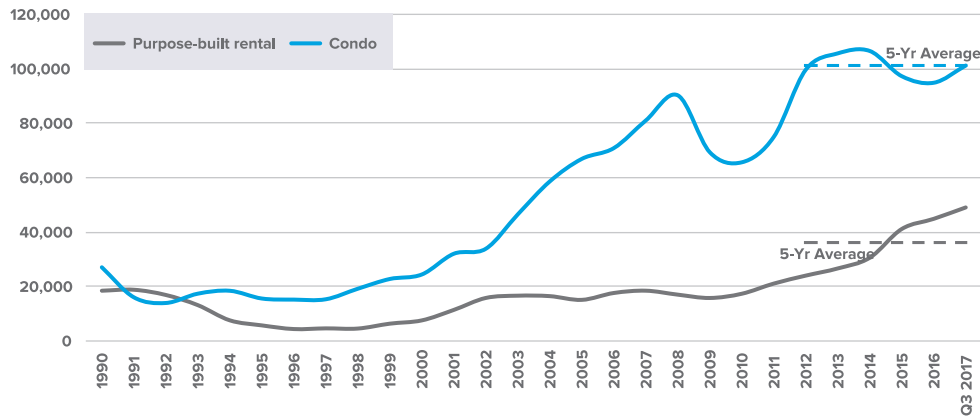
Adding to the strong demand drivers is an insufficient level of new supply. This supply shortfall exists despite elevated levels of completions this year of both purpose-built rentals and condominiums — which often attract upward of 50 per cent investor condo rentals. Purpose-built rental construction has increased to the highest level in decades, although it still forms less than half that of condo development. In Toronto, the market is increasingly reliant on the secondary condo rental market to meet rental demands.

#### 4.23 HOME OWNERSHIP RATES DECLINE ACROSS PRIMARY RENTER COHORTS



SOURCE: STATISTICS CANADA

#### 4.24 NATIONAL PURPOSE-BUILT RENTAL DEVELOPMENT INCREASING BUT STILL ONLY HALF OF CONDO



SOURCE: CMHC

# 2X

NUMBER OF CONDOS UNDER CONSTRUCTION TO PURPOSE-BUILT RENTAL

Purpose-built rental currently under construction in Toronto is well below the national average and that of most major cities, as expressed per capita. When comparing the total level of new construction (condos and purpose-built rentals), the market is under supplied relative to five-year averages. Physical land constraints, a long entitlement process and increasing land costs all contribute at varying degrees to an insufficient amount of new supply.

#### LARGER UNITS IN HIGH DEMAND—ARE DEVELOPERS BUILDING THE RIGHT TYPE OF HOUSING?

Whether it's an aging millennial starting a family, an empty nester downsizing or a divorcee looking for an apartment close to the former family home, demand for larger units to accommodate evolving lifestyles is on the rise. We've witnessed increased momentum in rent growth in larger units as the historical rent per square foot premium of one-bedrooms over two-bedrooms has been eroded. Two-bedroom rents in To-

ronto are now commanding a premium in some neighbourhoods. This poses an interesting question. Are developers building enough larger units to meet the changing preferences of renters? Looking at suite mixes of projects under construction in Toronto suggests that developers have yet to grasp the breadth and depth of the two-bedroom market. A bulge in the 25-34 age cohort will shift to the 35-44 age cohort over the next ten years and with many choosing to be lifetime renters, they are likely going to prefer more space as incomes and families grow. Larger units are also more often found in purpose-built rentals as opposed to condominiums where developers typically favour smaller one-bedrooms geared more towards an investor-owner. Growing demand and a shortage of suitable accommodation, provides an opportunity for purpose-built rental developers.

#### MULTI-RES FUNDAMENTALS TIGHTEN

Given the current trends in the market, there's little surprise that property fundamentals have tightened over the year. Conditions in Vancouver and Toronto remain heavily landlord favourable as vacancy rates decline well below their long-term average, leading to rental rates increases Y/Y. Although markets in Ottawa and Montreal are more balanced, they each experienced rent growth Y/Y as vacancy rates dipped below their long-term averages. Meanwhile, improved employment prospects have stabilized



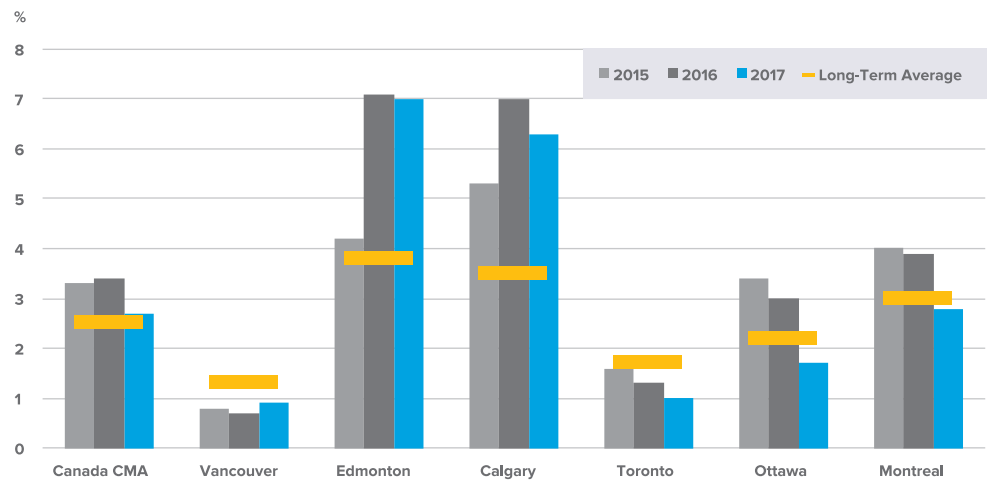


Two St. Thomas,  
Toronto

“Developers are re-thinking their suite mix strategy as we’re seeing increasing demand for larger units to meet evolving lifestyles”

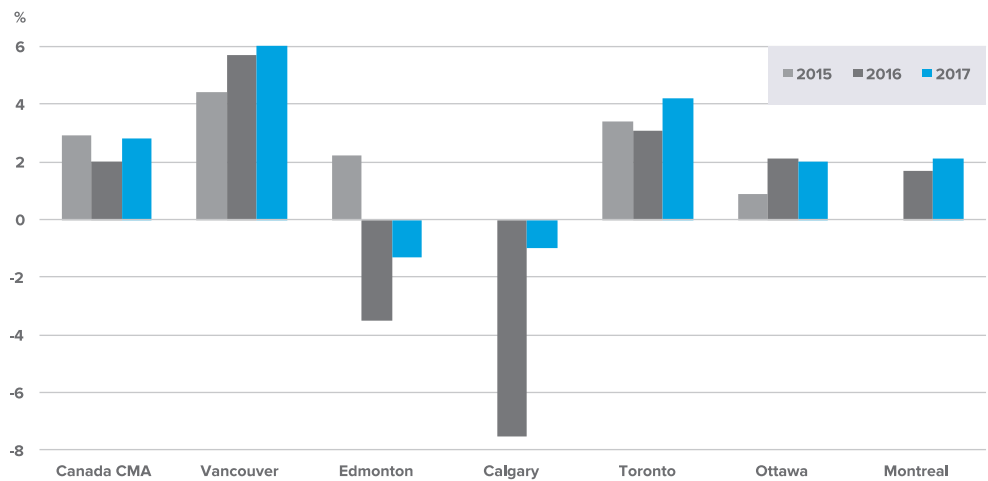
—GARY LEE, SENIOR VICE PRESIDENT, RESIDENTIAL

#### 4.25 APARTMENT VACANCY DECLINES ACROSS MOST MARKETS



SOURCE: CMHC

#### 4.26 STRONG PURPOSE-BUILT APARTMENT RENT GROWTH IN VANCOUVER AND TORONTO



SOURCE: CMHC



Portfolio,  
Calgary

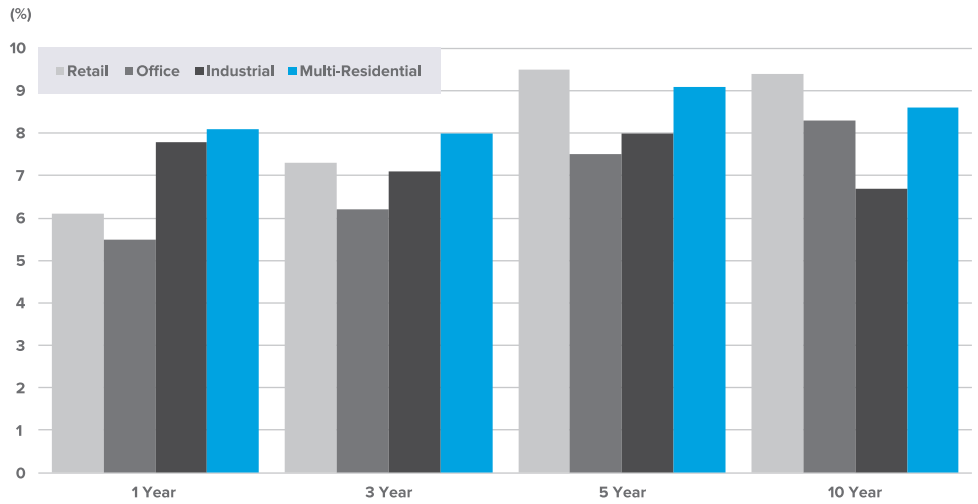
an upward trend in vacancy in Calgary and Edmonton. While rent growth has yet to materialize in Alberta, landlords are at least experiencing stabilization in eroding net operating income, as significant tenant inducements had been commonplace in order to protect occupancy.

**RETURNS LEAD THE INDEX FOR A SECOND YEAR IN A ROW**

A favourable rent-growth environment has driven NOI higher and cap rates lower, resulting in the highest total returns for any property sector in the IPD Canada Property Index for the second

year in a row at 8.1 per cent for the four-quarter trailing as of Q3. Not surprisingly, Vancouver (13.9 per cent) and Toronto (11.2 per cent) led the way with double digit returns and Alberta was the worst performing, although Calgary has experienced positive returns in each quarter of 2017. Looking ahead, rent control in Ontario could exert upward pressure on cap rates but rent growth (to the extent that landlords can access it through unit turnover) should help to mitigate these increases. The same is true in landlord favourable markets across the country where rent growth prospects should help to mitigate rising interest rates.

**4.27 MULTI-RESIDENTIAL RETURNS OUTPERFORMING**



SOURCE: MSCI REALPAC/IPD CANADA PROPERTY INDEX



# Bentall Kennedy Group

*Bentall Kennedy, a Sun Life Investment Management company, is one of the largest global real estate investment advisors and one of North America's foremost providers of real estate services. Bentall Kennedy serves the interests of more than 550 institutional clients with expertise in office, retail, industrial and multi-residential assets throughout Canada and the U.S. Bentall Kennedy's Investment Management group has approximately \$46 billion (CAD)/\$37 billion (USD) of assets under management (as of September 30, 2017). Bentall Kennedy is one of the largest real estate services providers in Canada, managing 60*

*million square feet on behalf of third-party and investment management clients (as of September 30, 2017). Bentall Kennedy is a member of UN PRI and a recognized Responsible Property Investing leader ranked among the top firms around the globe in the Global Real Estate Sustainability Benchmark (GRESB) for the seventh consecutive year since GRESB was launched.*

*Bentall Kennedy includes Bentall Kennedy (Canada) Limited Partnership, Bentall Kennedy (U.S.) Limited Partnership and the real estate and commercial mortgage investment groups of certain of their affiliates, all of which com-*

*prise a team of real estate professionals spanning multiple legal entities. The assets under management shown here include real estate equity and mortgage investments of the companies within Bentall Kennedy.*

*For more information, visit [www.bentallkennedy.com](http://www.bentallkennedy.com).*

## BENTALL KENNEDY RESEARCH TEAM

### **Phil Stone**

Vice President  
Head of Canadian Research  
(416) 681-7955  
[pfstone@bentallkennedy.com](mailto:pfstone@bentallkennedy.com)

### **Tom Vo**

Manager  
Research & Analytics  
(416) 681-2728  
[tvo@bentallkennedy.com](mailto:tvo@bentallkennedy.com)

### **Doug Poutasse**

Executive Vice President  
Head of Strategy & Research  
(617) 790-0851  
[dpoutasse@bentallkennedy.com](mailto:dpoutasse@bentallkennedy.com)

### **Paul Briggs**

Senior Vice President  
Head of U.S. Research  
(617) 790-0853  
[pbriggs@bentallkennedy.com](mailto:pbriggs@bentallkennedy.com)

### **Frank Ramsden**

Manager  
Research & Analytics  
(617) 790-6333  
[framsden@bentallkennedy.com](mailto:framsden@bentallkennedy.com)

### **Carlos Ortea**

Assistant Vice President  
Research & Analytics  
(617) 357-6402  
[corte@bentallkennedy.com](mailto:corte@bentallkennedy.com)

### **David Levy**

Senior Vice President  
Head of Valuation  
(781) 819-7022  
[david\\_levy@newtowertrust.com](mailto:david_levy@newtowertrust.com)

*Bentall Kennedy (Canada) Limited Partnership*

**Toronto**

1 York Street, Suite 1100  
Toronto, ON M5J 0B6  
t 416 681 3400  
f 416 681 3405

**Vancouver**

Four Bentall Centre  
1055 Dunsmuir Street, Suite 1800  
Vancouver, BC V7X 1B1  
t 604 661 5000  
f 604 661 5055

**Calgary**

1300, 112-4th Avenue SW  
Calgary, AB T2P 0H3  
t 403 303 2400  
f 403 303 2450

**Edmonton**

10303 Jasper Avenue NW, Suite 1750  
Edmonton, AB T5J 5C3  
t 780 990 7000  
f 780 990 7024

**Montréal**

1155, rue Metcalfe, Bureau 55  
Montréal, QC H3B 2V6  
t 514 393 8820  
f 514 393 9820

**Ottawa**

50 O'Connor Street, Suite 610  
Ottawa, ON K1P 6L2  
t 613 230 3002  
f 613 563 3217

**Winnipeg**

615 One Lombard Place  
Winnipeg, MB R3B 0X3  
t 204 589 8202  
f 204 582 3115

*Bentall Kennedy (U.S.) Limited Partnership*

**Seattle**

1215 Fourth Avenue  
2400 Financial Center  
Seattle, WA 98161  
t 206 623 4739  
f 206 682 4769

**Boston**

One Federal Street, 25th Floor  
Boston, MA 02110  
t 617 790 0850  
f 617 790 0855

**Chicago**

30 S. Wacker Drive, Suite 1250  
Chicago, IL 60606  
t 312 596 9140  
f 312 775 0965

**San Francisco**

600 California Street, Suite 560  
San Francisco, CA 94108  
t 415 375 4014  
f 415 772 5607

**Washington, DC**

7315 Wisconsin Avenue, Suite 200 West  
Bethesda, MD 20814  
t 301 656 9119  
f 301 656 9339

On the cover: 640 5th Avenue SW, Calgary

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