CANADA

Perspective

MID-YEAR 2018

ECONOMY

Canadian economic growth downshifting

CAPITAL MARKETS

Insatiable appetite for commercial real estate despite rising interest rates

PROPERTY MARKETS

Fundamentals continue to strengthen

Bentall Kennedy

Contents

Property Type Metrics

VACANCY / AVAILABILITY

ABSORPTION

NEW SUPPLY

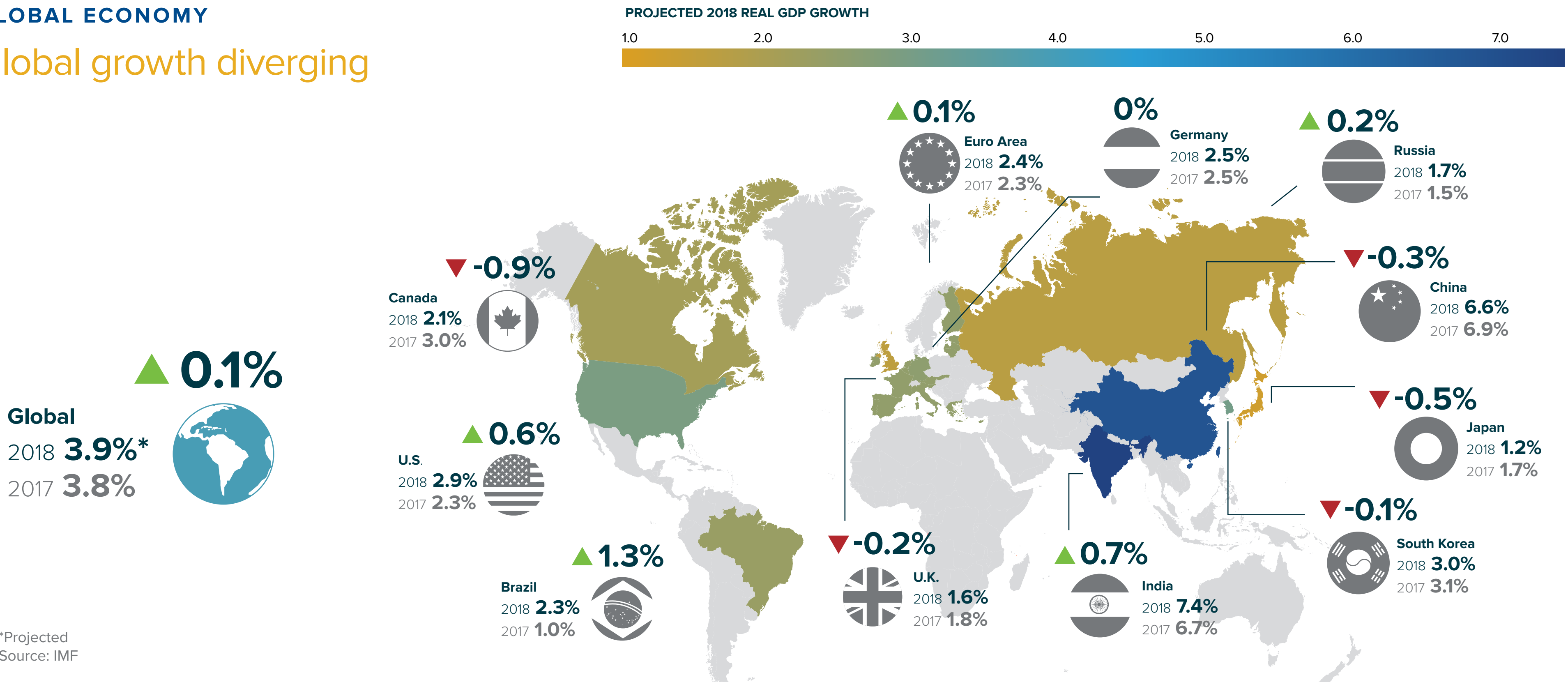
RENT

BENTALL KENNEDY RESEARCH SENTIMENT

Positive ⟷ Negative

GLOBAL ECONOMY

Global growth diverging



*Projected
Source: IMF

ECONOMIC
Global growth moderating

U.S. economic growth accelerated, while growth moderated elsewhere, particularly in the euro area and Japan.

China's GDP growth has stabilized, albeit at a pace that is significantly slower than the previous decade.

Protectionist policies pose a risk to global trade flows. Tensions are escalating as the U.S. implements tariffs on imported goods from China, Canada, and other nations.

GEOPOLITICAL
Political tensions threaten outlook

Uncertainty surrounding the looming "Brexit" and Italy's political and financial struggles has clouded the outlook for the euro area.

Military posturing between North Korea and the U.S. has subsided for now, but the dissolution of the Iran nuclear deal puts the Middle East back in the spotlight.

Ongoing border and immigration disputes further strain U.S. and Mexico relations. Meanwhile Venezuela's new government could amplify social unrest across South America.

FINANCIAL
Volatility returns

Despite healthy corporate profits, global equity markets have been weaker and more volatile in 2018.

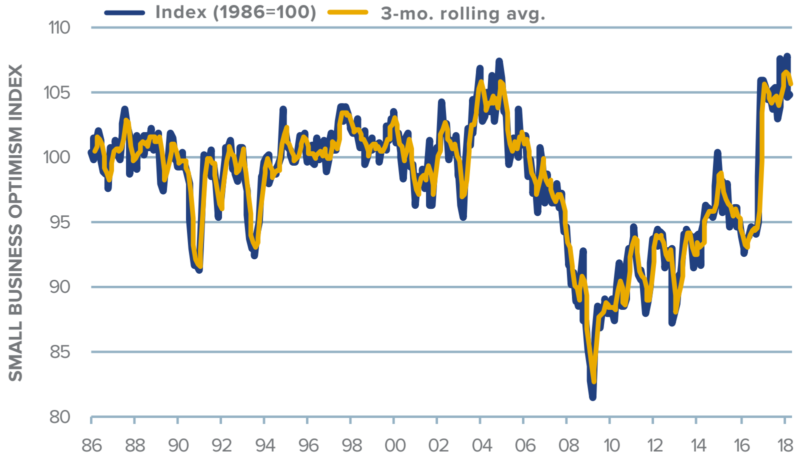
Risk of contagion from political unrest in the euro area and the prospects of trade wars could prolong capital market volatility.

While healthier economic fundamentals justify less accomodative monetary policies, a brisk transition towards higher rates could have undesired consequences.

U.S. ECONOMY

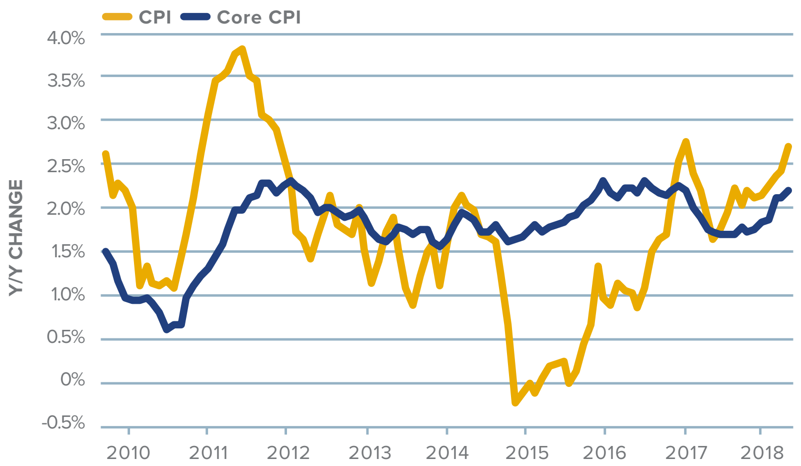
A persistent U.S. expansion

U.S. businesses feel optimistic about the economy



Source: National Federation of Independant Business (NFIB)

Signs of inflation finally cropping up



Source: U.S. Bureau of Labor Statistics

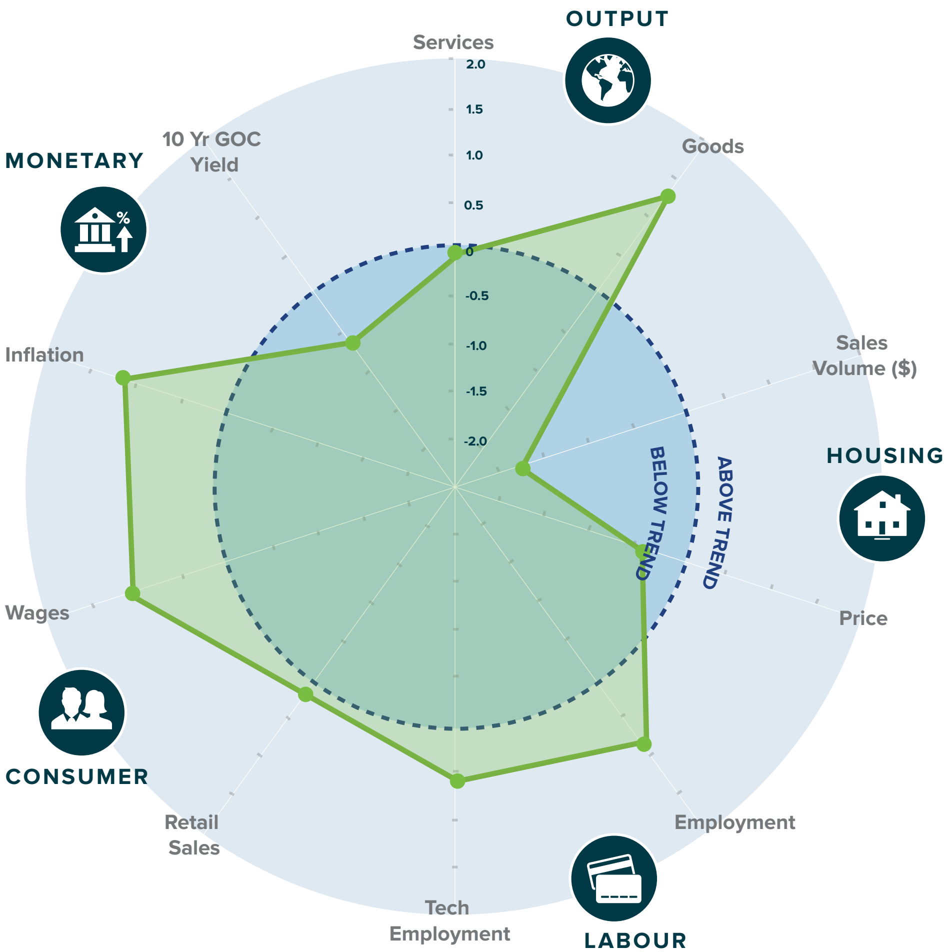
- Most indicators point to real GDP growth of near 3% in the U.S. for 2018 as government spending and tax policy invigorate businesses. Small business optimism is near record highs.
- Trade disputes and the possibility of a full-fledged trade war represent the most pressing economic risk. That said, the impact of already announced tariffs should be minor.
- Major inflation indices are rising, prompting the Fed to continue to raise rates. A total of four hikes in the Fed Funds rate seems likely in 2018.
- Oil prices are up dramatically from a year ago, contributing to higher inflation. Gas prices could have a modest cooling effect on consumption this summer.
- The flattening yield curve is a material concern for the economic outlook. When short-term rates rise above long-term rates it generally foreshadows a recession as banks reduce lending.
- This dynamic creates a dilemma for the Fed as it tries to temper inflation with higher short term interest rates.
- Global demand for stability and yield will continue to keep longer-term Treasury yields low. In a global context, 10-year U.S. Treasury yields are relatively high.
- The U.S. labour market continues to impress with growth not materially changed from a year ago. Year-over-year as of May employment was up 1.6% or 2.4 million jobs.
- Unemployment is at its lowest level since 1969 and looks to head lower. For the first time on record, the number of job openings exceeds the number of unemployed individuals.
- This tight labour market is supporting wage growth, but it also represents a headwind as expanding employers encounter a shortfall in available skilled labour.

CANADIAN ECONOMY

Moderating growth on the horizon

Following an impressive 2017, economic growth in Canada is easing to a more sustainable pace. Macro conditions are generally healthy but some facets of the Canadian economy are underperforming relative to long-term trends.

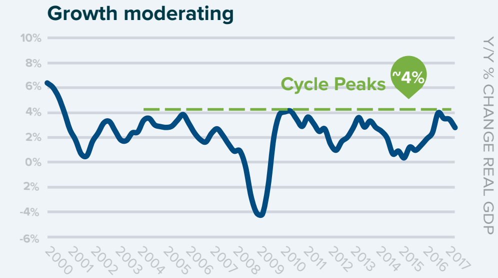
Economic indicators relative to long-term trend



*Metrics are Y/Y growth with the exception of 10 Yr GOC Yield
*Ranked by standardized z-score where 0 indicates long-term trend
Source: Bank of Canada; Bentall Kennedy; CREA; Haver Analytics; Statistics Canada

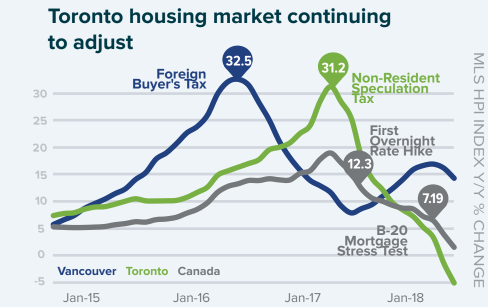
OUTPUT

Real GDP growth peaked at 4% (Y/Y) signalling a convergence towards long-term trend. The goods producing sector has been a main driver of economic activity but could be negatively impacted by any unfavourable outcome involving NAFTA.



HOUSING

Housing activity has cooled due to provincial policies in B.C. and Ontario, higher interest rates and the implementation of the B-20 mortgage stress test.

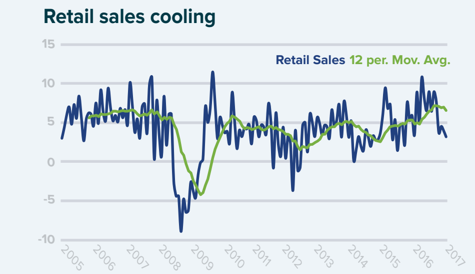


LABOUR

The labour market is producing jobs at a healthy pace. The majority of the new jobs created are full time which signals improving business confidence. Unemployment is at a 10-year low, with a rate of 5.8%.

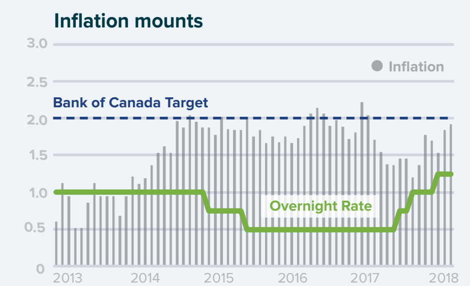
CONSUMER

Retail sales are showing signs of slowing as consumers prepare for higher debt-servicing costs. Tighter labour market conditions are exerting upward pressure on wage growth, lending support to consumer spending.



MONETARY

As inflation builds, the Bank of Canada is committed to gradually tightening monetary policy. The overnight rate is expected to rise another 50 bps by year-end. Meanwhile the 10 year GOC yield is higher Y/Y but remains historically low.

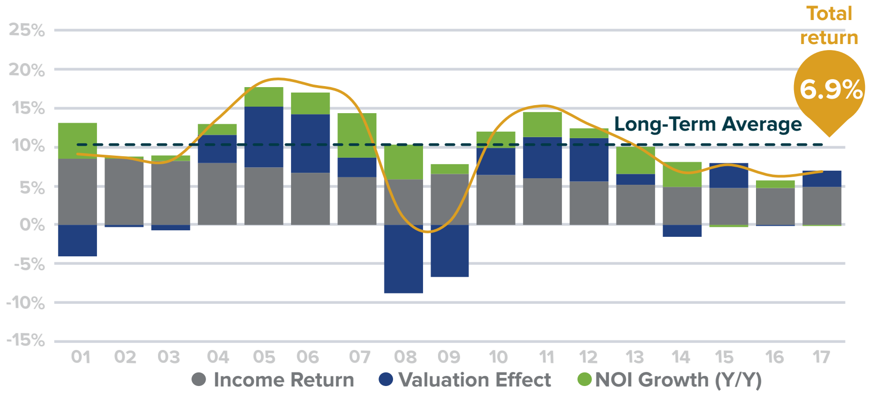


CAPITAL MARKET OVERVIEW

Strong transaction volume driving pricing to new highs

Returns moderating but continuing to generate stable cash flow

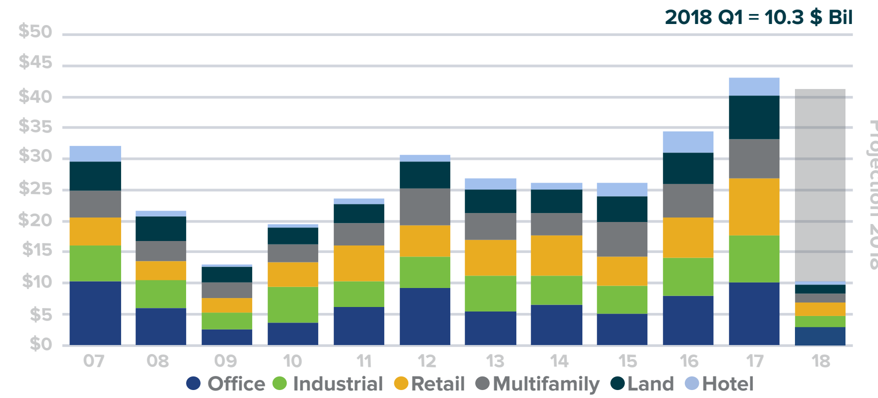
Investment Return Decomposition



Source: MSCI REALPAC/IPD Canada Property Index, Standing Investments, 12-month trailing as of Q1 2018

Investment volume remains elevated to start the year

Canadian Real Estate Transaction Volume



Source: CBRE

ASSET VALUES

Asset pricing remains strong as demand for quality assets outstrips supply.

Rising interest rates exerting upward pressure on cap rates but the impacts vary by sector, geography and idiosyncratic risks.

Weight of investment capital and healthy operating fundamentals bode well for property prices outside of the retail sector and Alberta.

INVESTMENT RETURNS

Future returns will likely be income oriented with capital appreciation driven mainly by NOI growth.

No signs of overbuilding due to disciplined capital markets—helping to promote continued stability in income returns.

Risk-adjusted returns remain attractive relative to other asset classes.

EQUITY CAPITAL

Global search for yield continues to attract more capital to the asset class.

Record investment volume in 2017, while 2018 is quick out of the gate with a number of large deals announced.

No shortage of equity capital looking to be deployed, including: private equity, foreign investors, and institutions/pension funds with increasing allocations to real estate.

DEBT CAPITAL

Debt sill readily available and competitively priced for high quality assets.

Attractive lending spreads are drawing capital to the debt market although competition is causing compression.

Underwriting is becoming more conservative and delinquency rates remain near historical lows.

OFFICE

Toronto and Vancouver outperforming while challenges remain in Alberta

Vacancy

12.5%

Vacancy
As of 18Q1

Quarterly Vacancy Trend

10-YEAR AVERAGE VACANCY
10.0%

- Conditions are tight in Vancouver and Toronto, especially in their downtown markets where class A vacancy rates are currently at 5.3% and 2.9% respectively.
- In line with a rebounding Alberta economy, Calgary's office market is stabilizing. However, downtown class A vacancy rate in Calgary remains elevated at 21.9%.

Source: CBRE

Absorption

7.4

Million SF
Four Quarters Ending 18Q1

Quarterly Demand Trend

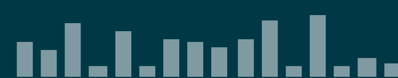
10-YEAR AVG. ANN. DEMAND GROWTH
3 MILLION SF

- Office using employment growth has been supportive of leasing activity. Meanwhile a rapidly growing tech sector has been another source of organic office demand.
- With a lack of quality space in downtown markets, suburban demand has gained momentum.

New Supply

6.0

Million SF
Four Quarters Ending 18Q1



Quarterly Supply Trend

10-YEAR AVG. ANN. SUPPLY GROWTH
6 MILLION SF

- The development pipeline remains active with 13.1 million sf under construction. Due to a steady flow of completions, construction volume has been declining from its cyclical peak of 22.9 million sf.
- The majority of development activity is taking place in Vancouver and Toronto, especially downtown where developers are looking to capitalize on tight conditions.

Rent

-3.5%

Y/Y Growth
As of 18Q1

Quarterly Y/Y Rent Trend

10-YEAR AVG. ANN. RENT GROWTH
0.5%

- Consistent rent growth has not materialized at a national level due to soft conditions in Calgary and Edmonton. Alberta landlords continue to focus on occupancy at the expense of rent growth.
- Downtown Toronto and Vancouver markets have registered strong rent growth. Quality space in downtown Montreal is also registering gains, supported by an improving economy.

OFFICE

Tech growth accelerates

A rapidly expanding Canadian tech sector is a driving force underpinning office demand. Measured by both industry (NAICS) and occupational (NOC) employment classifications, tech is expanding at an impressive pace.

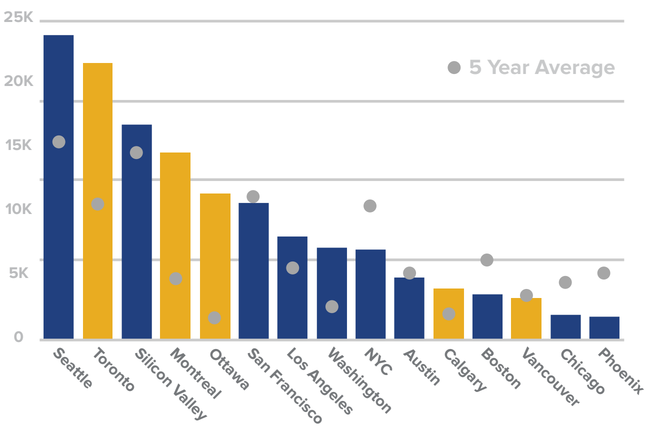
Tech vs. Total Employment

	INDUSTRY	OCCUPATION	TOTAL EMPLOYMENT
2017 Y/Y	14.5%	6.5%	2.3%
5 Yr CAGR	6.4%	4.5%	1.2%

Source: Statistics Canada
*NAICS: Total Employment Within a Tech Industry
**NOC: Total Tech Occupations Across All Industries

Canada punching above its weight

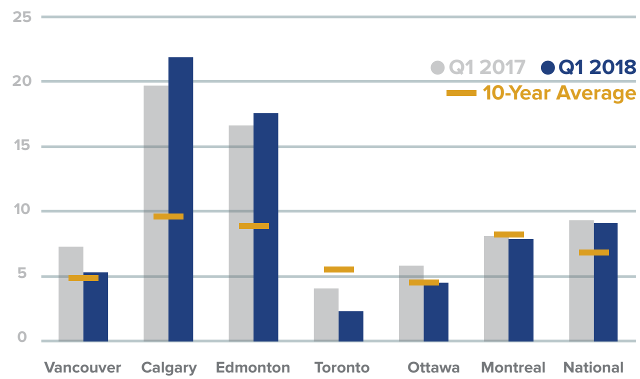
Tech Jobs Created (2017)



Source: Statistics Canada, U.S. Bureau of Labor

Tight conditions in most downtown markets

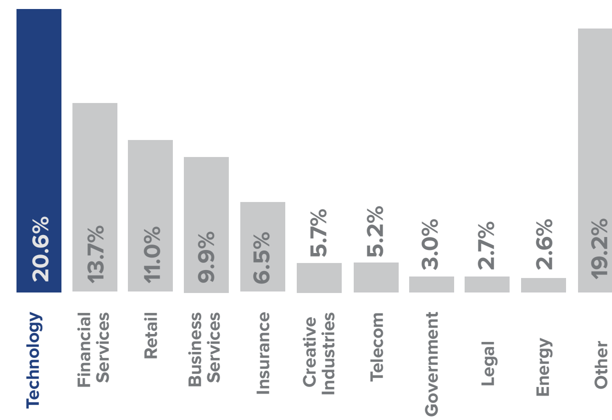
Class A Vacancy (%)



Source: CBRE

Tech talent base to remain active

Office users in the market for space, Q1



Source: CBRE

EMPLOYMENT

Canadian cities are punching well above their weight in tech job creation relative to other North American cities. Toronto, Montreal and Ottawa are outperforming their 5-year trend. Vancouver is holding its own and is poised to see further growth as Amazon has committed to expanding its workforce—now one of the largest single occupiers of office space in the city.

Why has Canada become so attractive for technology companies?

- Canada has maintained an open immigration policy, at a time when the U.S. is closing off its borders.
- It's home to first class universities with world leading researchers in emerging fields like artificial intelligence and robotics; and
- It has a talented labour pool at a relatively low cost when compared to other major U.S. tech markets.

OFFICE DYNAMICS

Tech tenants locate and cluster in urban areas to maintain close proximity to a young, talented labour force. As a result of strong job growth, downtown real estate demand from tech firms continues to accelerate.

Vancouver, Toronto, Montreal and Ottawa have all experienced significant compression in their downtown vacancy year-over-year.

With no material office supply relief for the next couple of years in downtown Toronto and Vancouver, transit-oriented suburban nodes could become more attractive.

DEMAND OUTLOOK

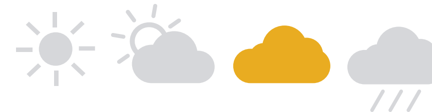
Across user groups currently looking for space, demand from tech leads the way, significantly outsizing traditional office using sectors such as financial and business services.

Tech companies have been at the forefront of shifting leasing models like co-working, but demand for flexible space is now on the rise with larger enterprises that are looking at office space as a service.

Other industries are increasingly embracing the "tech model" of more collaborative space arrangements, increased workspace density, and health and wellness initiatives—not only to attract and retain employees, but to also to improve productivity.

RETAIL

Divide between winners and losers becoming more pronounced



Vacancy

6.2%

Vacancy

As of 17Q4

Annual Vacancy Trend

10-YEAR AVERAGE VACANCY
5.2%

- Sears Canada closed its doors adding ~15 million square feet of vacancy to the market—most of which is concentrated in regional enclosed malls.
- Property fundamentals remain generally healthy for urban formats, super-regional malls and neccessity-based retail, while challenges remain for regional malls and power/community centres, particularly those in secondary and tertiary markets.

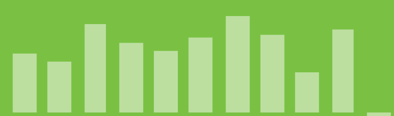
Source: CBRE, MSCI REALPAC/IPD

Absorption

-0.4

Million SF

Four Quarters Ending 17Q4



Annual Demand Trend

10-YEAR AVG. ANN. DEMAND GROWTH
5 MILLION SF

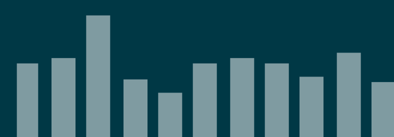
- Net absorbtion turned negative in 2017 for the first time in a decade, largely as a result of Sears closing shop. Re-leasing those locations that don't possess superior demographic profiles will be challenging to do accretively.
- Changing spending patterns, including increasing growth in e-commerce, rising demand for experiential retail offerings, and a growing concentration of sales in urban retail nodes are disrupting space demand.

New Supply

4.5

Million SF

Four Quarters Ending 17Q4



Annual Supply Trend

10-YEAR AVG. ANN. SUPPLY GROWTH
6 MILLION SF

- 4.5 million square feet of retail space (1.5% of total stock) was delivered to the market in 2017—rather evenly distributed across the country. However, 70% of the space currently under construction is concentrated in Toronto, Vancouver and Montreal.
- Capital investment continues to be focussed on urban mixed-use developments with a greater propensity to redevelop or reposition existing assets as opposed to building new construction.

Rent

0.3%

Y/Y Growth

As of 17Q4

Annual Y/Y Rent Trend

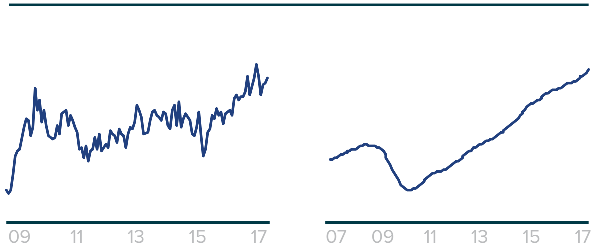
10-YEAR AVG. ANN. RENT GROWTH
2.1%

- Mounting cyclical consumer headwinds (higher interest rates, weaker housing market) should soften demand. Retailers continue to optimize store counts and footprints which is generally viewed as a net decrease in retail space. These factors are constraining rent growth.
- Rent growth will likely be isolated to the best assets within top tier trade areas, as well as necessity-based retail with a catchment possessing strong household incomes.

RETAIL

Canadian consumer health check

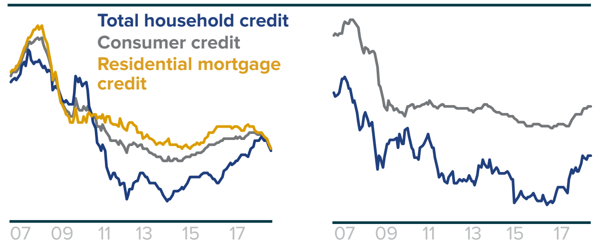
CONSUMER SENTIMENT



Consumer confidence
(Index 2014 = 100)

Auto sales
(Millions 12-Month Total)

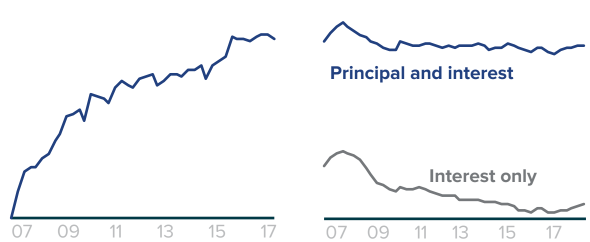
CREDIT



Household credit growth
(Y/Y % Change)

Interest rates
(%)

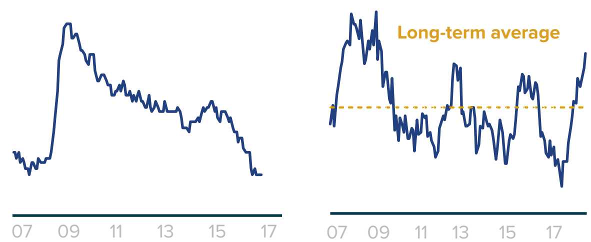
HOUSEHOLD BALANCE SHEETS



Debt to disposible income
(%)

Debt service ratio
(% SAAR)

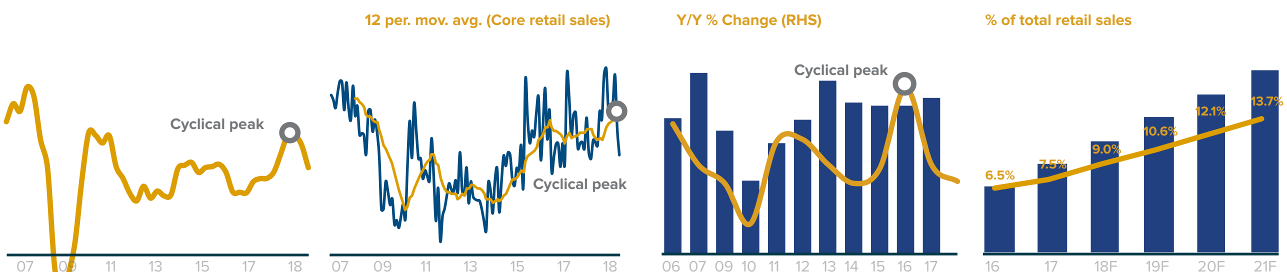
LABOUR MARKET



Unemployment rate
(%)

Average hourly wage growth (Y/Y % Change, 3-month MA)

EVIDENCE OF MORE MODERATE GROWTH



Real Household consumption
(Y/Y % change)

Core Retail sales (Y/Y % change)

Mall sales productivity

Canadian Ecommerce activity
Sales ($billions)

How long can the current pace of spending be sustained?

Despite the "doom and gloom" headlines portrayed in the media, retail sales growth in Canada reached the highest level in a decade in 2017. However, cyclical tailwinds are shifting as a cooling housing market and rising interest rates pose a threat to the continued growth in consumer spending.

Consumer sentiment remains strong while demand for durable goods such as autos is at an all-time high. Wage growth is firming as a result of considerably tight labour market conditions—running at a 3.9% Y/Y rate of growth through May. This should translate into more disposable income for consumption.

Household balance sheets are generally in good shape and the rate of debt accumulation is tapering off in response to slower housing activity and rising interest rates. However, slowing mortgage credit growth is likely to weigh on home-equity debt-driven consumption. Barring a major economic shock leading to significant job loss, household debt levels appear manageable.

Evidence of slower growth is already emerging as real household consumption and core retail sales appear to have peaked. Together with the rise in ecommerce, these shifting cyclical headwinds are likely to have an outsized effect on the discretionary product segments that comprise the bulk of the square footage in enclosed shopping centres.

INDUSTRIAL

Macro and structural factors remain supportive but trade is a risk to the outlook

Availability

4.0%
Availability
As of 18Q1

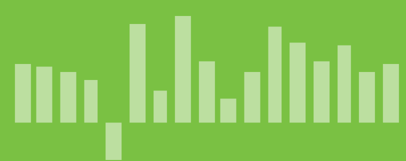
Quarterly Availability Trend

10-YEAR AVERAGE AVAILABILITY
6.0%

- Availability continues to decline—currenlty at a 15-year low. The macroeconomic environment should continue to provide a favourable backdrop helping to keep conditions tight.
- Vancouver and Toronto remain among the tightest industrial markets in North America. Meanwhile, Montreal's industrial market is showing signs of strength on the back of a much improved economy.

Absorption

21.8
Million SF
Four Quarters Ending 18Q1



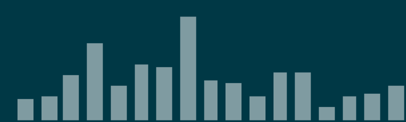
Quarterly Demand Trend

10-YEAR AVG. ANN. DEMAND GROWTH
15 MILLION SF

- The industrial market is largely dependent on the production and logistics of non-commodity goods. As such, consumer driven wholesale trade and manufacturing activity have been drivers of leasing activity.
- As retailers focus on optimizing supply chains, industrial space within close proximity to urban centres is garnering more attention.

New Supply

8.3
Million SF
Four Quarters Ending 18Q1



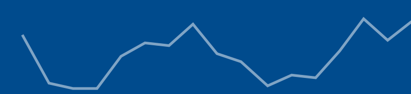
Quarterly Supply Trend

10-YEAR AVG. ANN. SUPPLY GROWTH
15 MILLION SF

- Construction levels are well below 2015 cyclical peak—largely due to rising replacement costs which have outpaced rent growth.
- However, accelerating rent growth should improve development economics, particularly in Toronto, Vancouver and Montreal.

Rent

4.5%
Y/Y Growth
As of 18Q1



Quarterly Y/Y Rent Trend

10-YEAR AVG. ANN. RENT GROWTH
1.9%

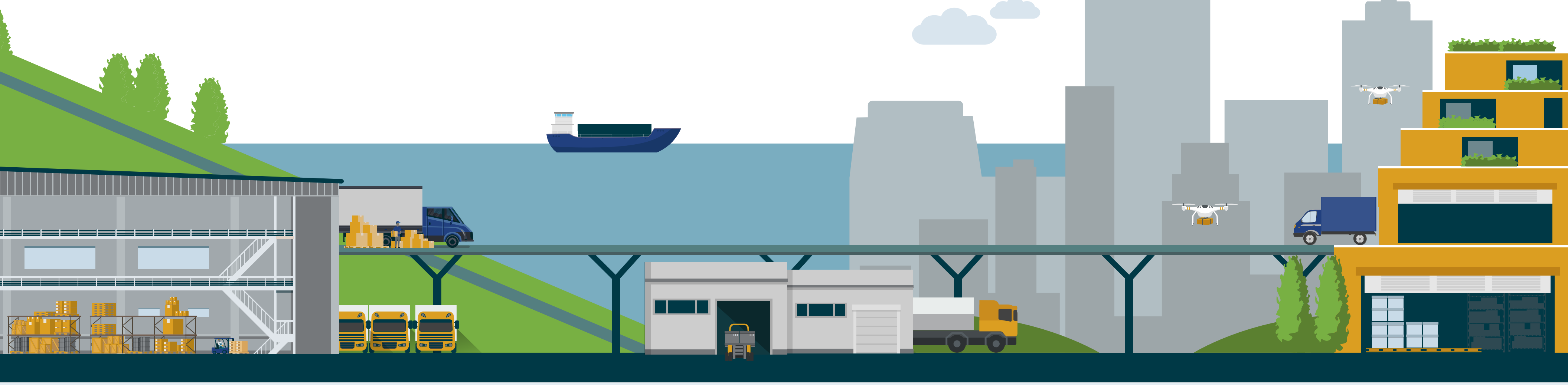
- Rent growth remains strong as absorption continues to outpace supply. Much of this lift is coming from Vancouver and Toronto where a dearth of quality space persists.
- Upward pressure on rents is expected to continue, particularly for locations close to major population centres and key transportations networks that provide access to labour pools.

Source: CBRE

INDUSTRIAL

Evolving supply-chains driving logistics demand

The emergence of ecommerce has forced supply-chain users to restructure how they deliver goods to their end-consumers. Expectations for same-day delivery and unlimited returns have placed a priority on speed and efficiency with a focus on end-to-end networks costs. As a result, location is becoming more important than ever.



Urban Logistics Spectrum

Big box distribution ⟵⟶ Light industrial

THROUGHPUT INNOVATION

Innovation in automated inventory storage and retrieval systems (AS/RS) is allowing for more efficient utilization of vertical and horizontal space. Buildings design specifications will continue to evolve to allow for greater volume of throughput per cubic foot.

RISE OF ECOMMERCE

Logistics demand is being amplified by ecommerce as sales continue to grow at double-digit rates in Canada. Estimates are that ecommerce fulfillment currently requires ~3x the logistics space compared to traditional bricks and mortar retail due to the "endless aisles" online and the challenges in handling returned items.

ROLE OF 3PLS

Third-party logistics (3PLs) are playing an increasing role in ecommerce fulfillment for many traditional retailers that typically don't have the in-house expertise. While 3PLs provide cost savings and efficiency, it could come at the expense of control over the distribution process and personalization of the packaging. High volume, low margin products are generally more suitable for outsourcing than the opposite.

RISING REPLACEMENT COSTS

Industrial land prices continue to escalate as development land becomes scarce and more investment capital is attracted to the property sector. However, construction costs are on the rise with significant increases in development charges along with upward price pressure on materials and labour as employment conditions tighten.

LABOUR FORCE AVAILABILITY

Fulfillment of the last leg to consumers is typically less dependent on robotics and sophisticated retrieval systems than larger bulk distribution facilities. As more manual labour is required, particularly during seasonal peaks, proximity to dense populations and access to public transit is critical.

INFILL CENTRES AND PICK-UP LOCATIONS

Demand is increasing for infill service centres where online orders arrive from larger warehouses to be sorted and packed for delivery to the end consumer. From here, crowd-sourced delivery and locker pick-up points are two trends that are reshaping the last mile.

MULTI-STOREY

As location becomes increasingly important in lowering transportation costs to deliver goods to end consumers, industrial rents for infill sites have more room for growth. Rents may reach a point in dense urban metros which would make multi-storey development economic for developers and compelling for users focused on "same-day" delivery.

MULTI-RESIDENTIAL

Strong tailwinds remain supportive for rent growth

Vacancy

2.9%

Vacancy

As of 17Q4

Quarterly Vacancy Trend

10-YEAR AVERAGE VACANCY
2.6%

- National vacancy is now trending lower due to the continued strength in Toronto and Vancouver and a bottoming in Alberta markets.
- Although vacancy sits above its long-term average, expect that tightening will continue given the strong macro tailwinds for the sector.

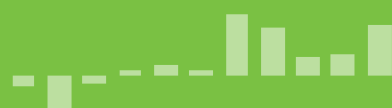
Source: CMHC, CBRE

Absorption

40K

Units

Four Quarters Ending 17Q4



Annual Demand Trend

10-YEAR AVG. ANN. DEMAND GROWTH
11K UNITS

- Absorption accelerated through 2017 as demand is driven by robust immigration and an improving labour market.
- Eroding affordability as a result of elevated home prices, rising interest rates and the new B20 mortgage qualification rules, will work to keep home ownership rates on the decline—supporting rental demand.

New Supply

23K

Units

Four Quarters Ending 17Q4

Annual Supply Trend

10-YEAR AVG. ANN. SUPPLY GROWTH
17K UNITS

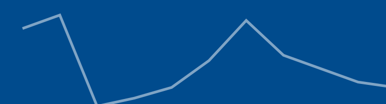
- New purpose-built rental supply continues to be delivered at or near record levels across most major markets.
- The construction pipeline is most active in Montreal, Vancouver and Toronto but on a per capita basis, Toronto is producing just half the number of units as Vancouver.

Rent

2.3%

Y/Y Growth

As of 17Q4



Annual Y/Y Rent Trend

10-YEAR AVG. ANN. RENT GROWTH
2.8%

- Rent growth continues to exceed provincially mandated caps on renewal increases in Toronto and Vancouver. Expect this trend to continue—although lower turnover rates are a headwind resulting from insufficient new supply.
- An economic recovery in Alberta is well underway resulting in improving rental demand which has minimized the inducements required to lease units—lifting net effective rents.

MULTI-RESIDENTIAL

Mortgage rules supportive for rental demand in the Greater Toronto Area

New OSFI B-20 mortgage stress test rules have impacted supply and demand for rental properties. It has limited mobility of move-up buyers and priced many renters out of the first-time buyers' market.

14.4%
Average GTA condo resale price increase Y/Y (Dec 2017)

200BPS
New qualifying interest rate increase per B-20

5.8%
Increase in condominium ownership costs as a percentage of median household income (Dec 2017)

19.0%
Purpose-built rent growth Y/Y in the GTA (building constructed post 2005)

Sources: CREA, Bank of Canada, RBC Economic Research, Urbanation

Effects of the mortgage interest rate stress test
Example for a median-income borrower

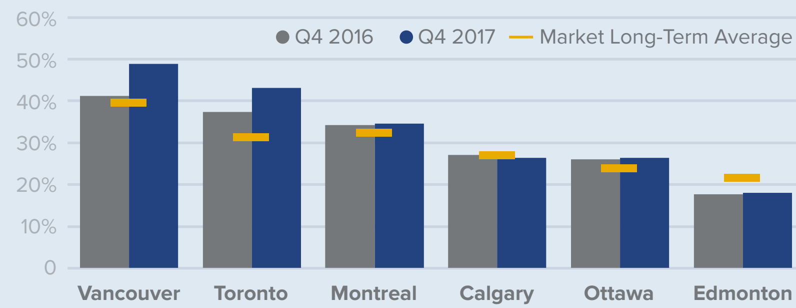
	No stress test	With Guideline B-20 stress test
Household income	$98,000	
Mortgage type	Uninsured, 5-year fixed-rate, 25-year amortization period	
Qualifying rate	3.69%	5.69%
Maximum loan size	$455,000	$373,000
Maximum loan-to-income ratio	465%	380%

Note: The income and the non-mortgage debt-service expense used in these calculations are based on the median characteristics of mortgage borrowers nationally in 2017. The qualifying rate in the "no-stress-test" example is based on prevailing five-year fixed mortgage rates for low-ratio mortgages from national mortgage brokers. Thresholds for the gross debt-service ratio and total debt-service ratio of 39 per cent and 44 per cent, respectively, are applied, although individual lenders can set their own thresholds.
Source: Bank of Canada, Financial System Review - June 2018

Condominium affordability deteriorating

Home ownership affordability continues to erode. According to RBC, condo ownership costs as a percentage of median household income increased by 5.8% Y/Y to 43.1% in the fourth quarter of 2017. Despite lower sales volumes condo prices continue to grow, albeit at a more moderate pace. In May 2018, the average sale price for a condo in the GTA increased by 5.7% Y/Y.

Percentage of median household income required to service the average condominium price



Source: RBC Economic Research

Eroding purchasing power has been a supportive for rental demand exerting downward pressure on vacancy and pushing rents higher. The average rent per square foot in purpose-built apartments constructed after 2005 increased 19% Y/Y to $3.00 in Q1 2018.

In the recent provincial election, "housing" was a top issue for 18-29 year olds in Ontario and the top issue for all voters in Central Toronto, according to Vox Pop Labs. Alleviating affordability challenges will be critical in attracting top labour talent to the GTA.

The new Progressive Conservative government has vowed to "maintain the status quo" in terms of rent control. Any immediate regulatory intervention is likely to address current supply issues which may include eliminating "red tape" and streamlining the approval process for new condo and purpose-built rental development.

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