Manulife Asset Management™

Canadian Commercial Real Estate Outlook

Will Rising Interest Rates Impact Canadian Commercial Real Estate Values?

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Introduction

With improved global economic growth expected over the next few years, many central banks are poised to gradually remove their monetary stimulus, potentially setting the stage for rising interest rates. In light of this, many investors are considering what impact an increase in interest rates will have on their commercial real estate portfolios. We believe that any impact on Canadian commercial real estate values from rising interest rates will be limited for three reasons. First, historic data does not show a constant relationship between real estate values and interest rates. Second, investment demand for Canadian commercial real estate continues to be very strong, which is supportive of valuations. Third, increasing rents and net operating income also supports valuations.

Historic Relationship between Real Estate Values and Interest Rates

Investors typically value commercial real estate based on an income return reflecting the relationship between a property's annual net income expectancy and value. This income return, commonly referred to as a capitalization (or 'cap') rate, is derived from a risk-free rate plus a credit spread or risk premium attributed to specific property features. Generally, a Government of Canada benchmark bond is used as a proxy by investors for the risk-free rate. With market consensus pointing to an increase in the risk-free rate,[1] there is a popular expectation that this will result in an increase in capitalization rates, which would negatively impact commercial real estate values.

Our observation of the movement of capitalization rates and risk-free rates over the medium term, as illustrated in Exhibit 1 below, suggests there is no consistent relationship between them. For instance, interest rates have been rising since November 2016 due to an expected rise in economic growth and higher inflation. However, capitalization rates fell during this period as a result of an improvement in fundamentals, attractive relative yield, and a rise in foreign investment. This would suggest there's an inverse relationship between capitalization rates and risk-free rates. However, contrast that to 2008, in the wake of the Global Financial Crisis, when negative sentiment pushed capitalization rates up sharply while risk-free rates first dipped as accommodative monetary kicked in, then rose. The ambiguous nature of the relationship between the two can also be seen between mid 2002 and mid 2005, when they appear to be falling in tandem. This is due in part to the credit spread embedded in the capitalization rate, which contracts and expands in response to other risk factors. The movement of credit spread is best illustrated in Exhibit 2 below. Given our economic forecast for a stable, growing Canadian economy, we believe the subsequent likely increase in interest rates will support and possibly improve commercial estate fundamentals, leading to credit spread compression, thus mitigating movement in the risk-free rate.

Exhibit 1: Cap Rates & Risk-Free Rates

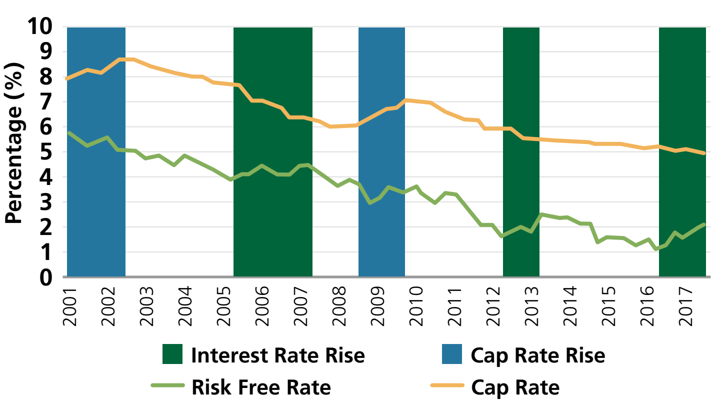
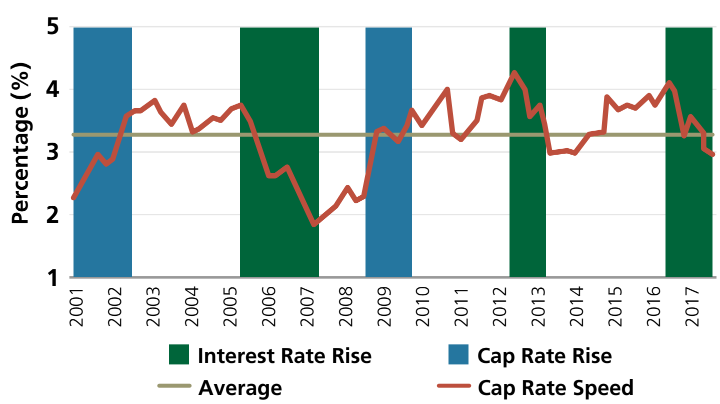


Exhibit 2: Credit Spread



Source: MSCI/IPD, Bank of Canada, Manulife Asset management, as of December 2017.

[1] Please refer to Manulife Asset Management Global Outlook for additional information about our five-year interest rate projection.

Strong Demand for Commercial Real Estate

Canadian commercial real estate returns have been both strong and stable over the last 20 years in comparison to returns from the global real estate markets. In our view, Canada's strong economy, robust governance framework and diversified investment markets are all supportive of continued strong and stable growth in the commercial real estate sector. These qualities explain in part why demand for Canadian commercial real estate, from both domestic and foreign investors, has increased over time. This is evidenced by both the 2017 commercial real estate transaction volume which is expected to exceed all previous years at over CA$40 billion, and the downward trend in capitalization rates since 2009, as depicted in Exhibit 2. Given these factors, and the relatively stable outlook of the economy, we expect continued strong demand for Canadian commercial real estate, which should in turn support and protect valuations and returns.

Income Growth, The Mitigating Factor

If risk-free rates were to rise in reaction to improved economic growth, we expect increased income to follow, thus mitigating the potential negative impact of higher rates. Since real estate is a required resource for many economic activities, economic growth would increase demand and reduce the availability of commercial space. The resulting lower vacancy rate would provide landlords with the opportunity to increase rents and improve net operating income. In fact, these market dynamics are already evident in many regions and sectors across Canada with occupancy levels rising and rental rates increasing as detailed in the Real Estate Market Outlook section earlier in this report.

In addition to demand-driven rent growth, there will likely be inflationary pressure in other inputs such as materials and labour, thus increasing the cost of construction and renovation. This provides further support for rent increases since the economic rent (the amount of rent that produces a reasonable yield on the cost of construction) will increase and new supply will be delivered only at higher rent levels.

With sustained economic growth, real estate investors may also consider substantial capital investments including property improvements and renovations to complete redevelopment with the goal of producing even greater income potential. The marginal expense of investing in existing properties can produce a greater net operating income at a lower economic rent than new construction.

Accordingly, we believe that any negative valuation impact that could be attributed to an increase in risk-free rates may be offset by a corresponding increase in net operating income through increased market rent, rent inflation and incremental investment in held properties.

The secular compression of yields over the past 30 years has been highly rewarding for those invested in long-duration assets, including real estate. With near term potential for increasing interest rates, investors appear to be focussing on the valuation impact this may have on their portfolio. As discussed above, Canadian commercial real estate returns have not shown a strong correlation to risk-free rates over the medium term. This, combined with the strength of the markets as well as potential for net operating income growth, leads us to believe the downside risk for valuations because of increasing interest rates is limited.

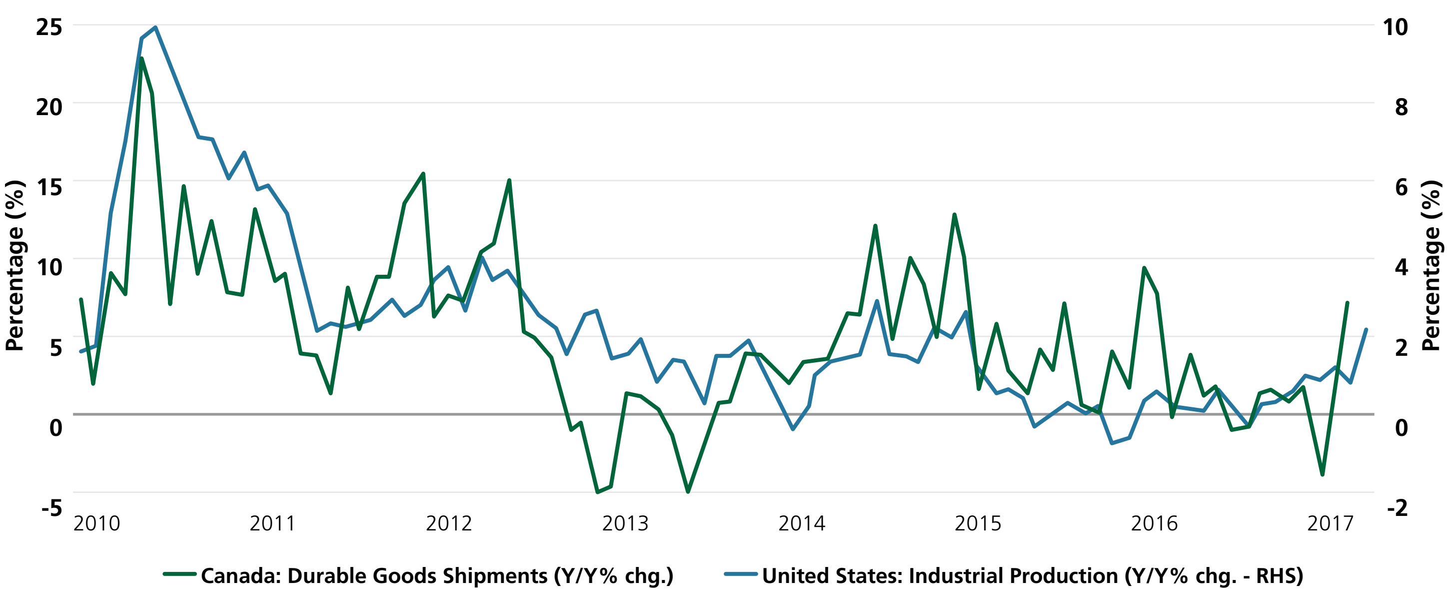
Strong Performance in 2017, Heading Towards Stabilized Growth

2017 was a strong year for Canada. After robust GDP growth in the first half of the year, expected deceleration in the latter half of the year was well contained and subsequent data in areas such as retail sales have shown signs of improvement and stability. The labour market has remained strong, with job gains and wage growth underpinning continued growth in consumption.[2] Stabilization in the energy markets helped Alberta's economy return to growth again, making it a top performing province in 2017.[3] Tighter housing restrictions in Ontario had their desired effect, with activity slowing and subsequently stabilizing without meaningfully impacting the broader economy. The overall economy's performance allowed the Bank of Canada to increase its policy rate twice over the course of 2017, which few would have expected at the beginning of the year.

Looking ahead, our five-year forecast for Canada is consistent with the rest of the developed world, calling for modest growth and well contained inflation. We do, however, expect a deceleration to below 2% in 2018 after 2017's strong 3.1 % growth, with the caveat that if the United States accelerates, Canada should be a beneficiary of increased US manufacturing activity as illustrated in the chart below.

There are several sources of uncertainty that could affect Canada during 2018. Central bank policy is one such area: since the Spring of 2017, the Bank of Canada's tone has shifted from dovish to hawkish and back again; while recent sanguine comments from Governor Stephen Poloz combined with reasonably stable economic data have pushed market expectations back towards being hawkish again. Geopolitics also require monitoring, with NAFTA negotiations being a key sensitivity for the year ahead. The residential real estate market is also an area of focus, with concerns of overheating local markets and tighter mortgage requirements that came into effect at the beginning of 2018. Other sources of uncertainty include Ontario's minimum wage increase and consumer leverage.

Exhibit 3: Canadian Durable Goods Shipments a Function of US Manufacturing Production



Source: Bloomberg, as of December 2017.

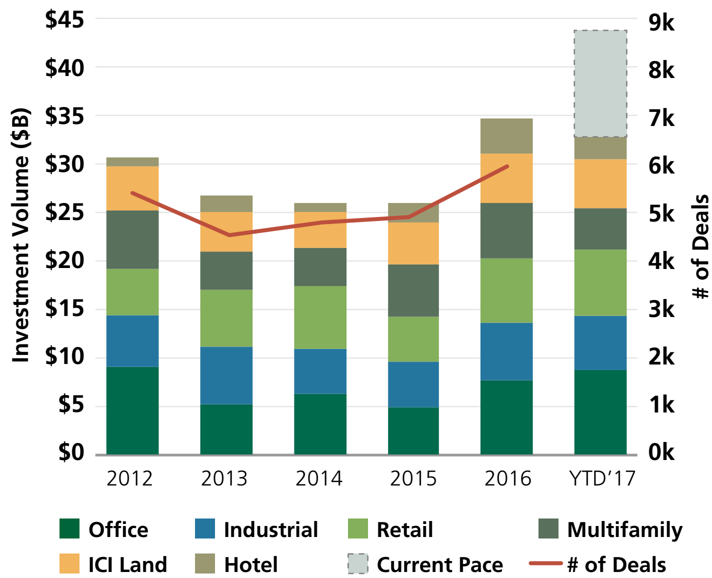
[2] Bloomberg: Canada's Economy Surges 4.5% on Consumer Spending, August 31, 2017.
[3] RBC: Alberta Back in the Saddle: To Lead All Provinces to Growth in 2017, September 8, 2017.

REAL ESTATE MARKET Q4 2017[4]

Investment Markets

Building off the record-setting pace seen over the first half of 2017, Canada is on track to set a commercial real estate investment volume record for the second year in a row. Investments into the sector totaled CA$11.0 billion in Q3 2017, bringing YTD national investment volumes to just under CA$33.1 billion. This is already greater than any full year prior to 2016 and the current pace suggests final 2017 numbers could blow past 2016 investment volume of CA$34.7 billion. These results have led CBRE to forecast that full year investment volume for 2017 will top the CA$40.0 billion level for the first time ever. The two most active asset classes for investment in 2017 have been the office and retail sectors which have seen capital flows totaling CA$8.9 billion and CA$7.0 billion, respectively, as of the end of Q3 2017. Regionally, the bulk of investor interest has been focused on the nation's two gateway markets of Toronto and Vancouver. Investments in these two markets have totaled CA$11.9 billion and CA$9.5 billion respectively so far year-to-date, dwarfing all other markets.

Exhibit 4: Historical National Investment Volume | 2012 - 2017

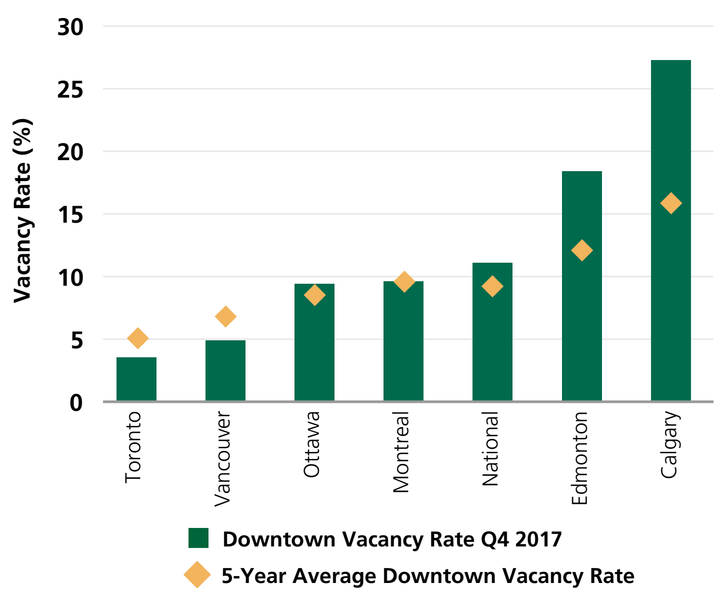


Source: CBRE Research, Realnet Canada, RealTrack Limited, Collette Plante, JLR Land Titles Solutions, Real Capital Analytics, Q3 2017.

Office Markets

The office sector finished the year on a high note, supported by strong market fundamentals in a variety of markets. The overall national vacancy rate compressed by 30 bps year-over-year, ending 2017 at 13.0%. The country also saw a five-year record high of 6.3 million sq. ft. in annual absorption in 2017. Canada's largest markets continued to tighten in Q4 2017 as downtown vacancy rates in both Toronto and Vancouver reached new lows, ending the year at 3.7% and 5.0% respectively, each significantly outperforming their five-year averages. Montreal's office market also made steady advancements towards achieving a vacancy rate in line with its five-year average, ending 2017 at 9.7%. Tightening vacancy rates in major markets have placed upward pressure on rents, a trend which should continue in 2018. Interestingly, the fourth quarter also brought encouraging news for Alberta, as Edmonton reported a second consecutive quarter of positive net absorption. Recent results from the province seem to be reaffirming the onset of recovery in the oil markets.

Exhibit 5: Downtown Office Vacancy Rates by Market | Q4 2017



Source: CBRE Research, Q4 2017.

[4] Real Estate Market Outlook provided by CBRE Research.

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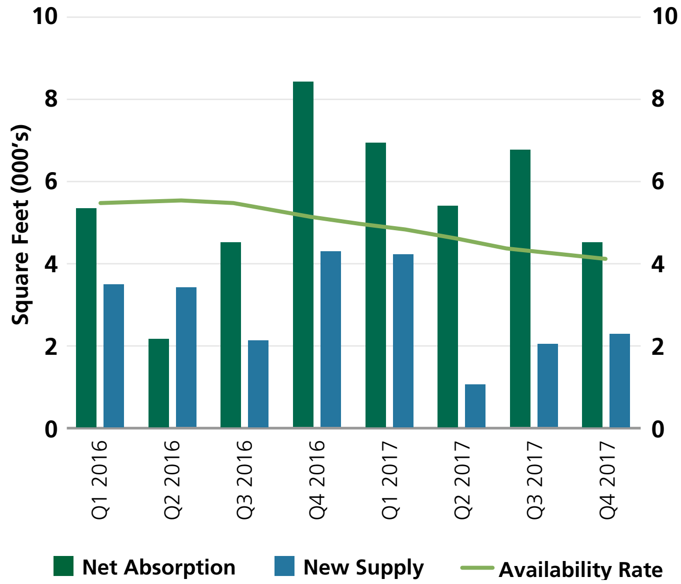
Industrial Markets

Canada's industrial sector continued to impress in Q4 2017 as market fundamentals reached new record levels. The national industrial availability rate compressed for a sixth consecutive quarter to 4.1% in Q4 2017, a 16-year low. While Canada's annual industrial net absorption reached a 10-year high of 23.6 million sq. ft., demand was constrained by a lack of available space in the nation's gateway markets. Toronto and Vancouver continue to claim the lowest industrial availability rates in major markets in North America, ending the fourth quarter at 2.2% and 2.3% respectively. This tightening has continued to put upward pressure on rental rates, which have grown 5.3% year-over-year to reach an all-time national record of CA$6.97 per sq. ft. Given tenant demand and a limited development pipeline, market conditions are unlikely to reverse in the short-term.

Exhibit 6: National Industrial Market Fundamentals | Q1 2016 to Q4 2017

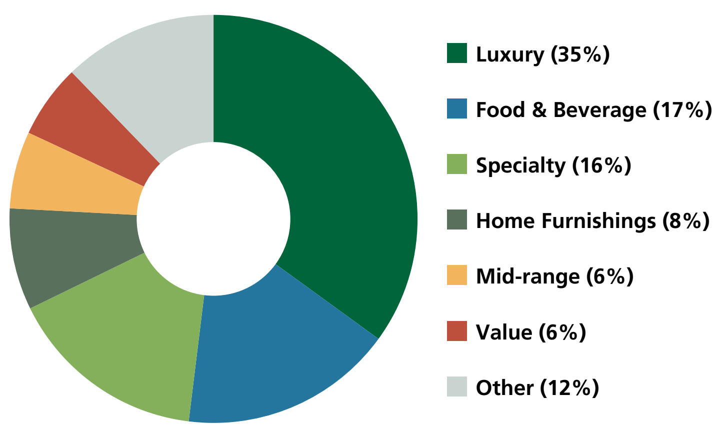


Source: CBRE Research, Q4 2017.

Retail Markets

Despite the often referenced list of retail closures over the past few years, 49 new international retailers set up shop in Canada in 2017. Canada has been a destination of choice for international retailers for several years now, with over 30 new entrants debuting on an annual basis since 2014. The majority of retailers that entered the market in 2017 chose either Toronto or Vancouver (33 and 11, respectively) as their first port of call in Canada and many of these merchants have indicated they plan to expand across the country in the coming years. On a category basis, luxury entrants led the pack in 2017, most of which hail from Europe (Switzerland: 6, Italy: 4, and France: 3). After a year filled with consistently positive results, the Canadian Consumer Confidence Index ended the year on a high note, finishing December at 128.4. This was the highest level the index has reached since 2009 and appears to be a good indicator that Canada will see continued interest from international retailers in 2018.

Exhibit 7: Categorization of New Retail Entrants | 2017

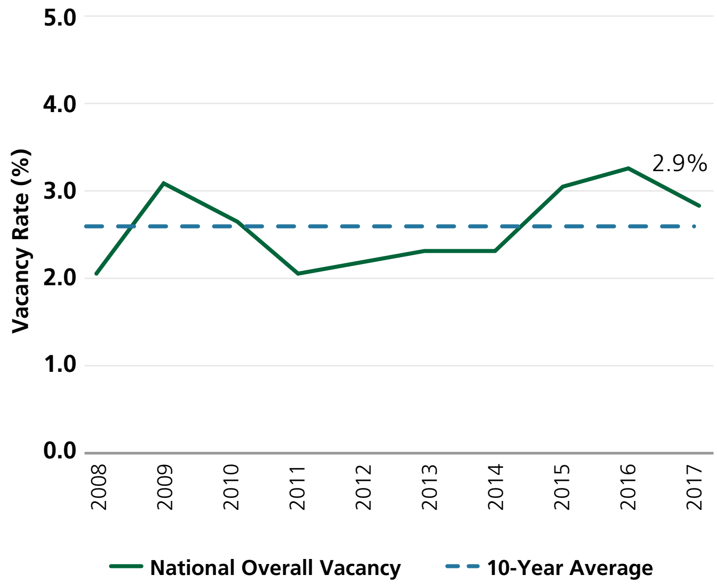


Source: CBRE Research, Q4 2017.

Multifamily Markets

As has been the case for much of the last 10 years, multifamily market fundamentals remained stable in 2017. Data released by the Canada Mortgage and Housing Corporation (CMHC) in October showed that the national average vacancy rate dropped to 2.9% in 2017, down 40 bps from the 2016 average of 3.3%. The drop in the national average was driven primarily by vacancy rate compression in Ottawa and Montreal (130 bps and 110 bps respectively). While most markets had vacancy rates below 3.5%, Calgary and Edmonton continue to feel the effects of the oil crisis, with comparatively high vacancy rates of 6.3% and 7.0%, respectively. The CMHC data also showed that national rental rates continued to increase in 2017 with the national average rental rate growing by 2.3% to reach an all-time high of CA$1,075. As high demand for housing persists and is met with limited supply, the multifamily sector is expected to continue to see low vacancy rates along with steadily increasing rents going forward.

Exhibit 8: National Multifamily Vacancy Rate | 2008 to 2017



Source: Canada Mortgage and Housing Corporation, October 2017.

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