Canadian Real Estate Outlook

"One foot on the gas, and the other on the brake"

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Introduction

In *Market Discipline: The Competitive Advantage: Lessons from Canada's Real Estate Leaders* (2012, REALpac), author William J. Ferguson, CEO of Ferguson Partners, Ltd., explored the unique attributes of the Canadian real estate industry that allowed it to fare far better than its U.S counterpart. Indeed, this has been Canada's time in the sun, with an enviable position of strength and potential for growth. Several factors contributed to this advantage, including: fiscal conservatism that translated into reduced leverage and solid risk management; prudent banking practices, such as minimal securitization and retaining more mortgages "on the books" of lenders; and a close-knit professional community, in which one's values and reputation are paramount.

Now, in this white paper, the view shifts to the future, the challenges and opportunities that will likely arise from the next 12 months to the next few years. To gain this perspective, we engaged in conversations with leaders in the Canadian real estate sector to learn what was top-of-mind for them, both opportunities and concerns, and what will shape the industry going forward.

Across the board, the common themes raised by Canadian leaders were:

- Institutionalization of the real estate sector, as pension funds, flush with capital, compete with real estate investment trusts (REITS) for prime properties, and the "cap rate compression" that is resulting from this competition;
- Macroeconomic factors, from the outlook for interest rates, which in Canada will follow the U.S., to global demand for products from Canada's resource-rich economy;
- Continued importance of leadership values to sustain the strength of the real estate sector, and to provide assurance to banks as lending tightens; and
- Strength and reputation in the Canadian banking system.

In the near-term, the outlook for the Canadian real estate sector is for continued growth and strong demand for premier properties by institutional buyers. There are some weak spots in the sector—for example in residential properties in Toronto, with some evidence of overbuilding condominiums. However, notable pockets of strength exist, such as industrial demand in western Canada, thanks to the strength of the long-term capital being invested in the energy sector.

One variable on the horizon is interest rates which, at some point, will increase. When this occurs, pressure will be put on development and deal flow. However, as the Canadian industry faces the next wave of inevitable cyclicality, no doubt the industry will rely on its leadership values that emphasize prudence and discipline.

Institutionalization of the Real Estate

"There is going to be more capital coming into the sector each year, particularly as more capital is available to the pension funds."

The Canadian real estate industry today is increasingly dominated by institutional players—pension funds and REITs. As more capital pours into pension funds, which prefer to allocate 5-15% of their holdings to real estate, their appetite for premium properties has become acute. In addition, since early to mid-2012, REITs have had more access to capital than they've had in years, which puts them in competition for properties with pension funds.

REITs and some of the very large Canadian pension funds have become aggressive buyers, to the point of elevating prices for better quality assets, compressing cap rates. "Frankly, these players are [sometimes] buying at rates of return that are not defensible for us," one real estate executive noted. "So it is creating a real pressure in the marketplace with a lack of quality product available at acceptable or reasonable pricing, and I think that's going to continue, with more pressure from the REITs and from some of the very large pension funds."

With more buyers than sellers, particularly for prime properties, this raises the question of how far down the asset chain these institutional players will migrate for investment opportunities. Typically, opportunistic investors have been the ones who pursued "B" and "C" class assets but, as one real estate executive noted, "pension funds are also sneaking into the same territory."

The growth of the real estate sector and the proliferation of REITs have also given publicly traded organizations the opportunity to become a larger force, and potentially play a more formative role in the Canadian real estate industry. REITS, which tend to have entrepreneurial management teams, are investing in urban redevelopment that would have been beyond the scope of their typical investment thesis just a few years ago. Executives did not predict that REITs would eclipse pension funds; however, REITs could become more involved "at the forefront of change" than they have been historically.

Another impact of the institutionalization of the Canadian real estate sector is less room for the private player, who dominated in the 1980s. Now, the market is described as being largely "driven by big owners and less by entrepreneurs." In fact, less capital is said to be available to entrepreneurs in general—although certainly some players, particularly those with long and impressive track records, have access to equity (and debt).

One important change on the horizon is net redemptions from pension funds as the population ages and funds need to start providing pensioners with income. This will be a crucial tipping point; timing, however, will likely vary from province to province, based on population demographics. Within specific markets, pension fund net redemptions will trigger the sale of properties, which could result in devaluation if the amount of properties that comes to market exceeds what can be absorbed. The expectation is that this will likely not occur in the next three to five years, but thereafter.

Macroeconomic Factors

"The near-term challenge is fairly straightforward: It's really the macroeconomic uncertainty that exists, more than anything else, because of uncertainty in the United States and, perhaps to a lesser extent, Europe."

For Canada, its major macroeconomic questions will be answered primarily by the strength of its trading partners, especially its largest, the United States. As one executive explained, "How the U.S. is doing drives how Canada is doing." Canada's resource-based economy depends heavily on demand from the United States and Asia, and to a lesser degree Europe.

The International Monetary Fund has projected modest economic growth in Canada for 2013 of 1.8%, down from an earlier forecast of 2% growth. For 2014, the IMF projects the Canadian economy will grow by 2.3%. Canadian officials have attributed weaker economic growth to decreases in business investment and reduced demand for Canadian exports, as well as more caution by consumers who are shying away from debt financing.[1]

The broad economic trends watched most closely by real estate executives include demand for exports such as lumber, with sales to the U.S. showing increases in the past six months, thanks to a recovery in U.S. homebuilding. Mining is also benefiting from sustained demand from China. Without question, the major economic sector is energy. Current oil production reportedly amounts to 2.7 million barrels a day, of which 2 million are exported (almost all to the U.S.). Exports are projected to increase because of oil sands production in

Alberta, with total petroleum production expected to reach 3.6 million barrels a day by 2015 and then to 5.4 million barrels a day by 2025, much of it flowing into the U.S. market.[2]

Increased oil production translates into the need for more pipeline capacity and new infrastructure projects, including west coast facilities to convert natural gas to liquefied natural gas for export. Although such development is viewed as being good for the economy (and, by extension, for real estate), leaders voiced some caution because of the regulatory and environmental hurdles to be crossed. In addition, in British Columbia, approval of any pipeline project would require review and approval by First Nation leaders.

Clearly, the economic issue that is top-of-mind for real estate executives is interest rates. As long as the U.S. continues to keep its rates at historically low levels, as it has since the 2008 financial crisis, Canadian rates will also be low. The consensus among real estate executives is for relatively stable, low interest rates for at least this year and perhaps into 2014. Once there are indications that the U.S. will raise its rates, Canada will likely move in front of it.

Within the real estate market, itself, executives gave a brief overview of some of the regional issues. Employment is described as very strong in Alberta and reasonably strong in British Columbia, and immigration flows are robust in both provinces. Western Canada is not viewed as being overbuilt in any of its key sectors, including condominium, industrial, retail, senior housing, and office space. With supply generally balanced with demand for properties, pricing is viewed as stable.

In eastern Canada, the condominium market is slowing in Toronto, although the urban market is holding up better than the suburban. The number of properties under development—one estimate pegged it at about 190 residential buildings under construction in Toronto alone—may presage further softening in that sector. The industrial sector has slowed in eastern Canada (compared to the west, where industrial properties continue to enjoy good demand). The eastern office market has picked up in the past five or six years, with use of cutting-edge technology in heating and cooling systems making newer projects more attractive.

The big news in both western and eastern Canada is in retail, with several U.S.-based retailers moving into the Canadian market. For example, Target has announced plans to open its first 24 stores in Canada by early April and has pledged to invest another C$1.5 billion in the country, as it seeks to offset weak sales in the U.S. The plan is for 124 Target stores to be opened in Canada by yearend. [3]

Overall, real estate leaders expressed cautious optimism about the Canadian economy that, while growing slowly, has held up well despite the recent malaise in the United States. As long as demand from the United States and Asia is steady to increasing, Canada should enjoy economic stability, at least in the short term.

Leadership Values

"Professionalism, discipline, values—

they're critical to what has brought us to where we are today."

A value system built on relationships has been a hallmark of Canadian real estate. As stated in *Market Discipline*, "Overall, the way leaders conduct themselves—their ethics, their sense of fairness—makes the difference between success and failure. In short, their leadership values are what make them successful in business."[4]

Values also enhance a sense of meritocracy, where people and organizations are judged by what they do and how they act. One's professional reputation and the kind of work someone is known for mean far more than the pedigree of school or background.

Going forward, leaders said, these values will be just as or even more important, particularly as the industry goes through the inevitable cyclicality. For example, executives described values as an important part of the evaluation equation as lenders, weighing proposals for financing, take into account an organization's track record, its reputation in the business community, and the confidence people have in the organization's leadership. "With lending in Canada likely to be more restrictive in 2013, there's just no question of the importance of values," an executive commented. "It's going to be more important than ever to have a good plan, to demonstrate discipline, and to show how the plan is going to be implemented."

Leadership values must also extend into another area of business—executive succession, particularly in REITs. The growth of these publicly traded entities has been due largely to strong founders, many of whom are still active in the business. The next challenge will be to create orderly, thoughtful succession plans.

Although REIT leaders were described as being far-sighted, these organizations are flatter and less hierarchical, which can limit the number of potential candidates and the breadth of their experience. “Nobody likes to talk about succession very much, which is understandable, but people are acutely aware of it and working towards addressing it,” one executive said.

A concerted effort is being made, leaders said, to attract younger executives to be groomed for leadership development opportunities. The hope is that this will lay the groundwork over the next five to ten years for what one executive described as “an organic, natural, healthy transition of leadership.” The advice for current REIT leadership is not to wait, but to be proactive in succession planning in order to have talent in place.

Succession will also pose some personal challenges to some of the “old guard” of Canadian real estate, many of whom are in their 60s, but continue to be active in the sector that they helped to build. (One elder statesman of the industry, when asked about his retirement, told a peer, “What would I do if I retired? I love the business.”) While the desire to remain engaged is certainly understandable, there is a danger that if current leadership does not give way gradually, the next generation could feel frustrated and thwarted.

Another part of succession, certainly, will be to ensure that the next generation of leaders inherits the same values that have provided a foundation of strength in the sector—enduring principles such as integrity, honor, and the belief that “your word is your bond.”

An examination of leadership values in Canada must also address personal character. To a person, the executives interviewed for this white paper (and, indeed, all those who were included in *Market Discipline*) did not brag about any accomplishments. Even when they described a deal that did particularly well or made a solid return for investors, these executives were more apt to cite favorable market conditions or being in the "right place at the right time." The only time the Canadian executives voiced anything close to a boast was when it came to the values of the sector overall. Then there was pride in their voices as they described leadership values that created great companies.

"Those values are going to be enduring, through good and bad times, and even through changes on the capital-markets side," one executive concluded.

Values, the executives agreed, contribute to stability in the sector because they curb overly risky behaviors and promote risk management. That's not to say the sector won't have its cycles of strength and weakness, and its setbacks (such as regional pockets of overbuilding). However, the industry has learned from past mistakes (e.g., over-speculation in the 1990s). More recently, during the global financial crisis, the industry witnessed the importance of strong values and fiscal conservatism. Therefore, moving forward, the Canadian industry is expected to continue to act in a disciplined fashion, with emphasis on personal integrity and leadership values, for the benefit of the sector and its community of players.

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