REALPAC | Ferguson Partners

REALPAC / Ferguson Partners Canadian Real Estate Sentiment Survey

Q4
2021

Table of Contents

Topline Findings	3
Data Collection	3
General Market Conditions	5
Asset Values	8
Debt Capital	9
Equity Capital	10
Participants	11

Exhibits

Exhibit 1A:	REALPAC/FP Canadian Real Estate Sentiment Index	5
Exhibit 1B:	Real Estate Roundtable Sentiment Index (U.S.)	6
Exhibit 2:	Perspectives on Real Estate Market Conditions	7
Exhibit 3:	Real Estate Asset Values	8
Exhibit 4:	Availability of Debt Capital	9
Exhibit 5:	Availability of Equity Capital	10

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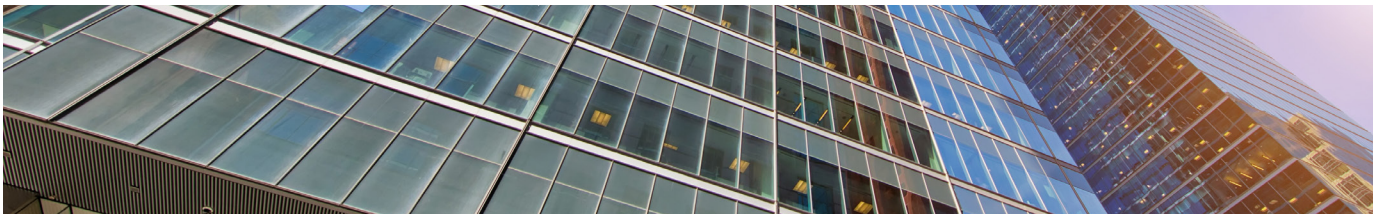
REALPAC (Real Property Association of Canada) and Ferguson Partners (FP) are pleased to announce the results from the fourth quarter 2021 REALPAC/Ferguson Partners Canadian Real Estate Sentiment Survey. The survey is the industry's most comprehensive measure of senior executives' confidence in the Canadian commercial real estate industry. This quarter, the survey captured the thoughts of a wide variety of industry leaders, including CEOs, presidents, board members, and other executives from a broad set of industry sectors, including owners and asset managers, financial services providers, and operators and related service providers. The quarterly survey measures executives' current and future outlook on three topics: (1) overall real estate conditions, (2) access to capital markets, and (3) real estate asset pricing. Survey respondents represent the retail, office, industrial, hotel, multi-family, residential, and senior residential asset classes.

Topline Findings

- Market performance remains highly dependent on asset class with industrial, residential, and niche sectors continuing to lead the way. Interest rates, immigration, ESG, inflation, labour supply, and the supply chain are all key considerations for market participants.
- Investor allocations to real estate continue to rise, leading to fierce competition for deals and elevated pricing.
- Debt capital is relatively cheap and available for certain sectors including industrial and logistics, residential, and development. With interest rates climbing, we should expect to see the cost of debt rise.
- There is an abundance of equity capital from both private and institutional investors.

Data Collection

Data was collected during October of 2021. In the pages that follow, survey responses are supplemented by excerpts from interviews conducted with senior executives from Canadian property developers and owners, institutional investors, asset managers, and other organizations.



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General Market Conditions and Key Real Estate Considerations

Market performance remains highly dependent on asset class with industrial, residential, and niche sectors continuing to lead the way. Interest rates, immigration, ESG, inflation, labour supply, and the supply chain are all key considerations for market participants.

"It's difficult to generalize about the market since [the] industrial and residential sectors are booming, and retail and office still have a way to go to hit bottom."

"I have no clue what [will] happen in the hotel market. We are not settled into a 'new normal' yet."

"Positives: [The] pandemic is ebbing; [there is] more normality; we are getting back to the office; [and there is a] wall of capital. Challenges: Out of control and hard project construction costs; municipal regulations and timelines are getting tougher; inclusionary zoning; Alberta is getting worse; office demand is hard to forecast; there is a wall of capital."

"Everything is very frothy - too frothy in my opinion."

"Capital markets are buoyant, fueled by easy access to low-cost debt; especially in multi-family rental, where leveraged returns remain attractive despite further cap rate compression. Multi-family fundamentals have turned the corner. We've seen persistent month-over-month rent growth in most markets since the spring as demand drivers have re-emerged. [There is] strong job growth, the return of students and office employees, increased immigration, and the continued erosion of homeownership affordability, which have all been positive for rental demand. Income-producing industrial is priced to perfection, supported by strong capital flows into the sector and a robust outlook on rent growth. Accordingly, our focus has shifted to development; where we see better risk-adjusted returns."

"Different segments of the CRE markets are performing quite differently. Industrial is hot, office is treading water, and retail is looking to re-invent itself."

"Market conditions vary by asset class. It is very difficult to generalize about the entire market."

"Return to office is so key as that will impact retail, office valuations, leasing velocity, etc."

"The real estate market is undergoing a compressed and advanced set of changes that normally would occur over a longer period of time as a natural evolution. This

is causing extraordinary situations. Historically, these situations have always normalized and I would expect the same. The strength of our Canadian market – owners, lenders, and the overall economy – will allow us to weather this bumpy landscape to a more normalized environment."

"Capital markets activity is very robust, especially around industrial, land, multi-residential, data centres, and life sciences. Office, retail, and hospitality are hit or miss. Debt and debt servicing is strong. No one is really afraid of escalating interest rates in the near term."

"Leasing is strong for industrial and life sciences. Office lags quite badly. We are starting to see activity pick up, but the Delta variant didn't help the return to office momentum started in June. Only positives ahead."

"ESG is the topic of the day and is being viewed by the industry as a 'surprise of intensity'. It is a topic that has been on the table, but investors are nervous about how fast the adoption and debate is moving. Europe is considering legislation to rank buildings as A-F compliant. The UK version being considered states that only A & B buildings will be allowed to let space until the building is upgraded and retrofitted. Legislation will give owners time; but its material, costly, and coming on fast. Also, top investors are using this strong, low interest rate environment to sell buildings (that will not comply in the future) now."

"Supply-chain issues, and the lack of workers have driven building costs up significantly; this will be with us in the near- and mid-term."

"I would describe the market as reasonably balanced. Borrowers are seeking debt financing for acquisition, repositioning, development, and refinance strategies. The demand is being met with a strong supply of funds from banks, credit unions, pension funds, life insurance companies, and private debt funds. Anecdotally, we are not hearing of properties experiencing financial difficulties."

"What does tenant demand for CRE space look like in a post-pandemic world? A rising interest rate environment, and ESG considerations are also key current considerations."

"[The real estate industry] is very optimistic about the recovery of the market. There has been a lot of uncertainty and speculation regarding inflation and interest rate movements. BoC had originally said rates would hold until 2023, and is now considering advancing that date to 2022. This will have follow on impacts to the housing market (affordability), and fringe players who rely on cheap debt to make projects work. Immigration is expected to open up, growing to over 400,000+ annually – this will continue to put pressure on housing affordability, especially in the rental space, where supply is not keeping up to projected demand.

Exhibit 1A:

REALPAC/FP Canadian Real Estate Sentiment Index*

*The REALPAC/FP Canadian Real Estate Sentiment Index and the Real Estate Roundtable Sentiment Index are measured on a scale of 1–100. Each are the average of a Future Index and a Current Index. To register an Index of 100, all respondents would have to answer that they believe conditions are "much better" today than one year ago and will be "much better" one year from now. The REALPAC/FP Canadian Real Estate Sentiment Index and the Real Estate Roundtable Sentiment Index, organized by Ferguson Partners, are created using the same survey methodology, questions, and timing.

The multi-family rental market has all but recovered to pre-pandemic occupancy and rent levels, despite a dramatic drop in the first 6-12 months of the pandemic. Condo PSF pricing in the core GTA has grown YOY, which is evident in the recent launches downtown that are selling at pre-pandemic volumes. Land prices have held in the core-urban markets, which continue to make building rental challenging, resulting in continued supply challenges as immigration opens up. Construction costs have escalated by double digits in 2021 making projects that were viable 12 months ago challenging to execute on. Rents and condo pricing (residential), despite the recovery, are not able to keep pace with the cost escalations resulting in compressed returns or in the worst case cancelled or repurposed projects. The continued international supply chain challenges and a growing desire to be in control of logistics domestically have made industrial the hottest asset class with little sign of cooling off. Rents are growing 8-20% (depending on the market), and there continues to be room for further appreciation as tenants are making larger investments in newer, more modern facilities. Suburban office leasing accelerated in early-2021, and has seen occupancy recover to pre-2020 estimates. There is a strong interest in 'satellite' office space, as well as from professional service firms (medical, engineering, etc.). Seniors housing is seeing some recovery, but it is muted compared to the more traditional real estate market. Occupancy levels in the major players dropped below 80% in the pandemic, and they are not expected to fully recover for another 12-24 months. With a desire to build 35,000 new long-term care beds, there continues to be an increasing interest in health science investment (i.e., campus of care concept); which is evident in the recent announcement of the McMaster Innovation Park project. Urban market fundamentals (GTA, Ottawa, Montreal, and Vancouver) are not significantly different from pre-pandemic levels; there continues to be a significant hesitation to invest in Alberta due to the volatility of the market despite recovering oil pricing."

"It's all about interest rates, and not whether they're going up, but when they're going up."

"You need conviction in your investment thesis, because not much makes sense relative to past real estate cycles."

"[The market is] surprisingly strong despite the pandemic. In general, owners are well financed and we don't see any significant distress. Most large owners have very diverse holdings so – despite concerns around office – the industrial, multi-family, and development land are hot so that balances the market."

"Low interest rates and ecommerce are driving the markets. Retail is not dead, but is changing to focus on guest experiences. Work-from-home is a huge concern in office and it may take two years to sort out what the new reality will look like, but early indications are that the majority of companies and employees will be back in the office by 2022 with some flexibility."

Exhibit 1B:

Real Estate Roundtable Sentiment Index (U.S.)*

*The REALPAC/FP Canadian Real Estate Sentiment Index and The Real Estate Roundtable Sentiment Index, organized by Ferguson Partners, are created using the same survey methodology, questions, and timing.

"The impact of inflation, supply chain delays/costs, and labour shortages; and how that will impact retail sales, manufacturing, and economic growth in general [are having an impact on the market]. Furthermore, how will this impact get extended to CRE? Specifically retail (potentially negative) and industrial, which is both negative and positive - potentially negative for manufacturers and retailers that find themselves in trouble, but likely positive as many are switching from just-in-time (JIT) to just-in-case (JIC); which requires additional warehouse space."

"Markets are recovering, although some are showing more resilience than others (Vancouver/GTA). The industrial/logistics asset class is experiencing strong growth in value driven by a combination of cap rate compression and increased leasing rates due to a generalized lack of supply/high demand for space. The multi-residential asset class is continuing to be a strong performer; [there is] some cap rate compression in certain markets with increased occupancy and rent starting to increase. The office market appears to be more or less stable/flat (still a bit of a wait-and-see approach to office occupancy). Considering that some employers are mandating vaccinations, and putting in place gradual return to work flexible strategies, the expectation is that 2022 Q1-Q2 will be more indicative of future leasing demand. Retail is recovering; centres with exterior access, and/or key anchor tenants are leading the pack. Malls are dealing with vacancies and this is likely to continue for a few years and will put pressure on rents. Retailers' growth is dampened by the lack of human capital resources."

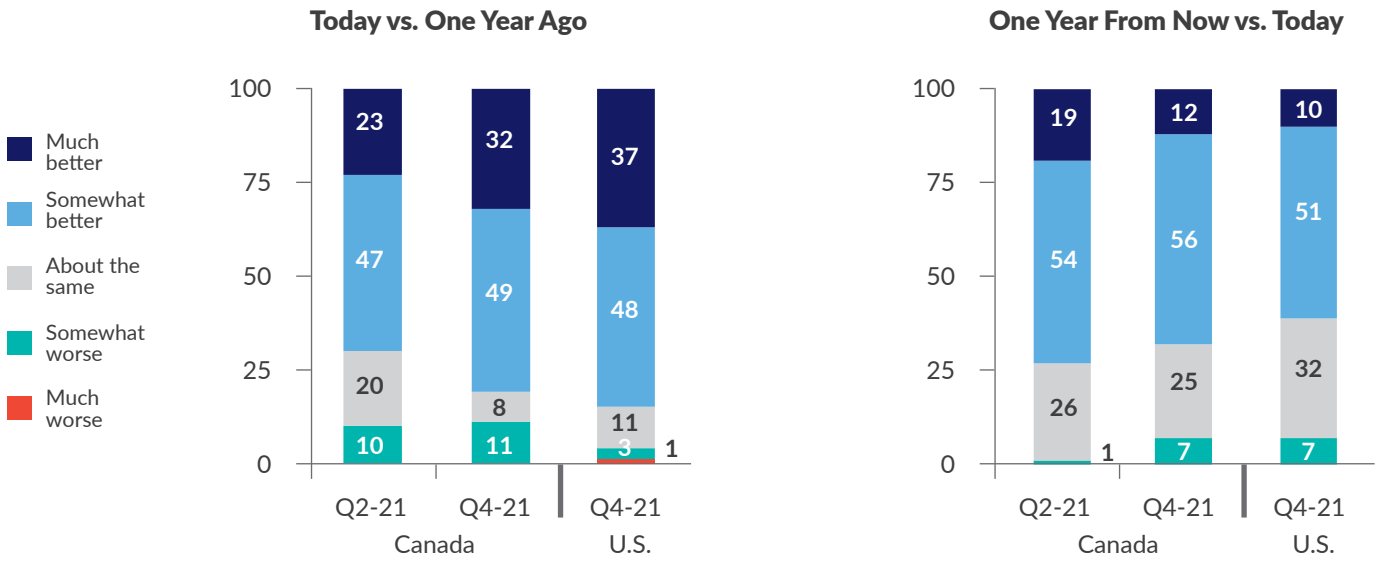
"Qualified resources are in high demand. We've noted a higher number of unfilled positions at the end of Q3, longer recruitment processes, and sometimes a need to adjust job specifications. We're expecting upward pressure on compensation as a consequence. This is felt in many sectors, including real estate."

"ESG is front and center. You cannot talk about an investment opportunity without covering this important area."

"Several institutional investors have announced their commitment to achieving a net zero target by 2050 or before, with some setting intermediary objectives. Investors with a long-term horizon pursuing a develop-to-core strategy are inquiring about buildings specs and design flexibility in order to meet these targets. LEED may not cut it."

"Climate risk assessment is now being integrated into the investment process of many investors, with larger investors leading/ advocating on this topic."

Exhibit 2: **Perspectives on Real Estate Market Conditions** (% of respondents)



Asset Values

Investor allocations to real estate continue to rise, leading to fierce competition for deals and elevated pricing.

"The high demand for CRE from investors has created a very competitive environment and aggressive valuations. Investors are banking on continued low cost of debt, and rising revenue from tenants."

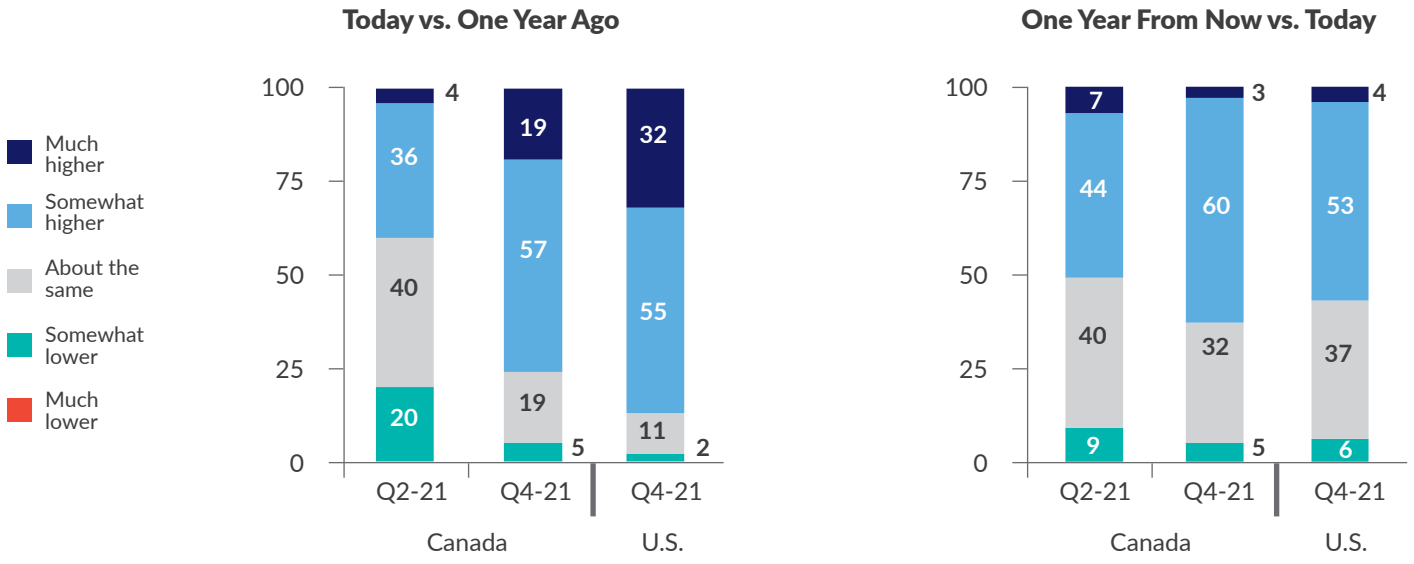
"Industrial is seeing double-digit appreciation. Retail with strong grocery/food anchored tenants has been flat and with some signs of recovery. Seniors will continue to decline somewhat until the recovery takes hold (it declined in 2020 too)."

"We seem to be reaching new pricing levels every day in the industrial asset class."

"Asset values are holding or soaring."

"The real estate market is stable and growing with increasing strength, as there is solid demand for most types of real estate due to population and income growth. In addition, the capital flowing to real estate as an alternative asset class is significant, so valuations are increasing."

Exhibit 3: **Real Estate Asset Values** (% of respondents)



Debt Capital

Debt capital is relatively cheap and available for certain sectors including industrial and logistics, residential, and development. With interest rates climbing, we should expect to see the cost of debt rise.

"The cost of debt is currently very low and plentiful. Borrowers have many options for debt financing, with attractive terms (interest rates, guarantees, interest only (IO) payment structures, long amortization periods, and wide range of terms available)."

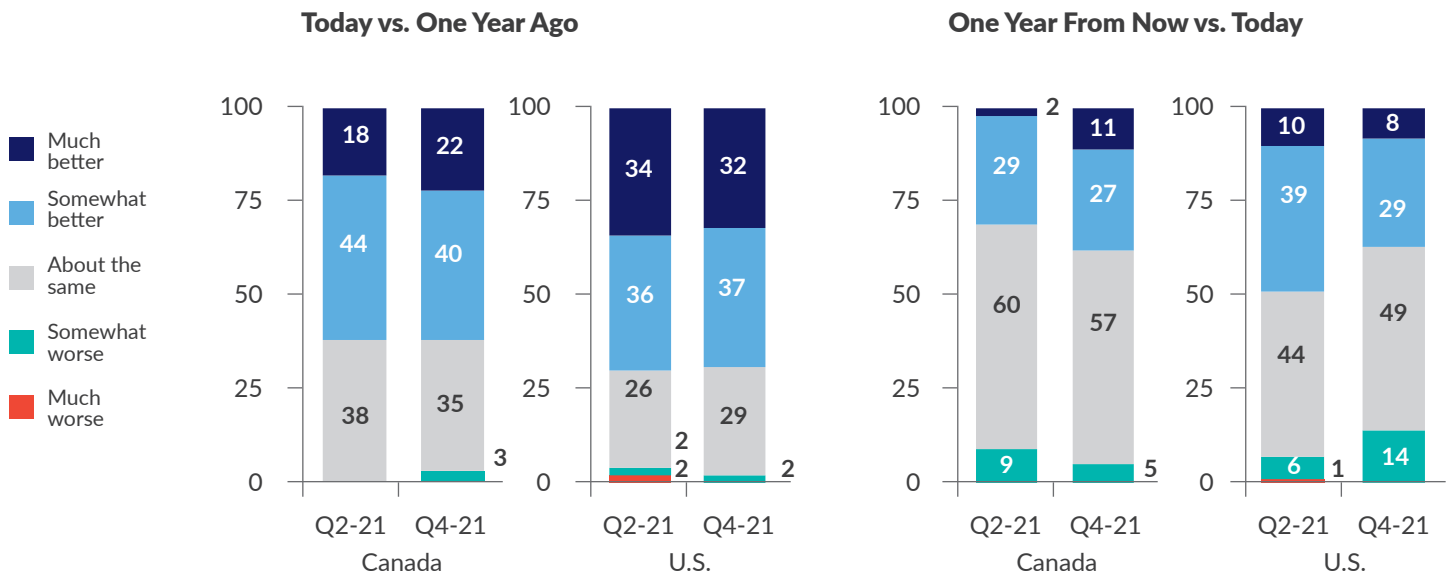
"Our debt strategy is very conservative – relatively low LTV on our core portfolio – so debt markets have been relatively easy for us to navigate. That said, we have seen some of the lenders get much tighter on terms (environmental, consents, etc.). Increasing appetite to do land loans through entitlement with rates very favourable, as long as there is a clear path to approvals. Construction debt rates and LTV has been very easy to attain with well capitalized groups. We do not use much in the way of mezz or secondary financing unless it is a short-term bridge."

"Better to go long and lock in now."

"[Debt capital is] still very available, but with more caution as interest rates look to climb."

"Debt capital availability is following investors' equity demand for an asset class (i.e., we see a significant availability of debt financing for industrial/ logistics/ multi-residential, including development.)"

Exhibit 4: **Availability of Debt Capital** (% of respondents)



Equity Capital

There is an abundance of equity capital from both private and institutional investors.

"Lots of capital looking for real estate."

"Equity capital is plentiful. The cost of equity is reducing as providers compete through price as a strategy to deploy funds."

"Following a tightening in 2020, there is a backlog of capital looking to be deployed. The appetite for industrial is insatiable – a lot of equity capital looking for groups who can acquire/develop industrial to fill their mandates. Despite some early hesitation in 2020, there continues to be strong demand for new multi-family product from pension plans. More groups showing interest in entitlement and development risk in the aforementioned asset classes, especially with groups who can show a clear pipeline in future years."

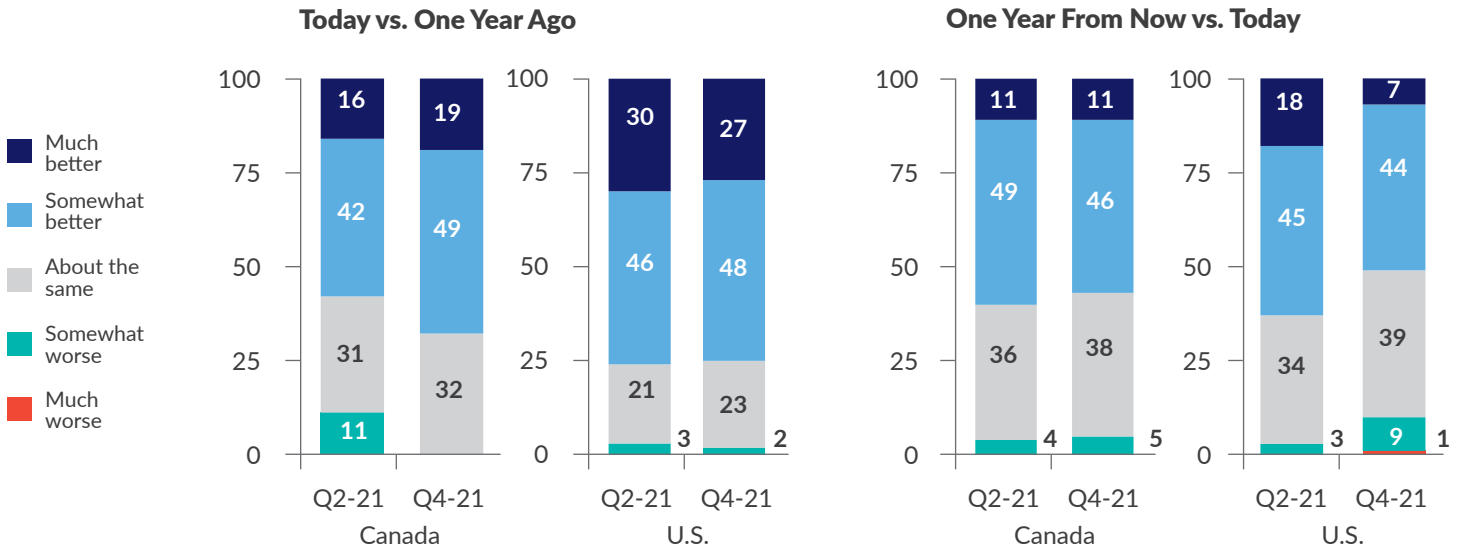
"Sticking to a strategy will be rewarded in the equity markets."

"Equity capital is abundant."

"Private investors are an important component of market activity, sometimes getting involved in larger transactions as well."

"A number of Canadian institutional investors are still dealing with larger retail exposure (and will be for a while). Others are trying to diversify outside of the country."

Exhibit 5: **Availability of Equity Capital** (% of respondents)



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(Please note that this is only a partial list. Not all survey participants elected to be listed.)

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