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Pension Fund Real Estate in the Great White North (eh!)

As has been the case for real estate investors globally, those Canadian pension funds that have accumulated well-diversified domestic portfolios have been rewarded over the past five years, as Canadian real estate has solidly outperformed bonds and equities (Exhibit 1). Again in 2004, for the nine months to September 30, real estate continued to be the strongest of the major asset classes.

Underlying this strong financial performance, Canadian property market fundamentals have been stable, if not spectacular. New supply has been kept generally under control, and Canadian job creation and space demand have been surprisingly strong; stronger in fact than U.S. demand during recent years.

Sound like a real estate investor's ideal scenario? To date that has been true, but as is also true everywhere else, abundant capital is now compressing returns such that seasoned investors worry that the cycle has entered a phase in which values have more downside risk than upside in the near term. The attainment of high-quality current income at a premium to bond yields and diversification benefits are the only compelling reasons to buy or hold Canadian real estate today.

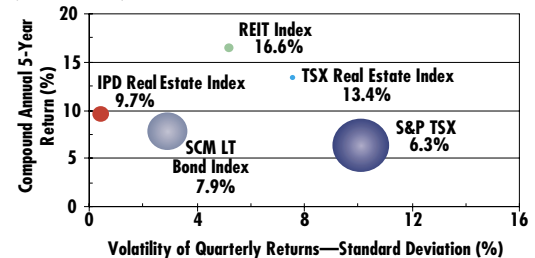
Existing portfolios are meeting those needs by generating resilient and predictable income in excess of most plans' actuarial requirements. The major Canadian space markets are forecast to remain largely in equilibrium, so income from core holdings appears to be defensive and sustainable. New acquisitions and the capital side of the equation, as everywhere else on the planet, are considerably more challenging.

Canadian Property Fundamentals

U.S. and Canadian business and interest rate cycles have been closely linked, and Canadian property returns have tracked those seen in the United States. Exhibit 2 tracks the returns of the NCREIF Property Index (NPI) and the comparable Canadian universe, the ICREIM/IPD, since 1986, when the Russell Canada Property Index (RCPI) began recording Canadian real estate returns.

Canadian returns have consistently followed those in the United States, although investors in Canada have experienced a slightly more pronounced cycle. The Canadian markets took two years longer

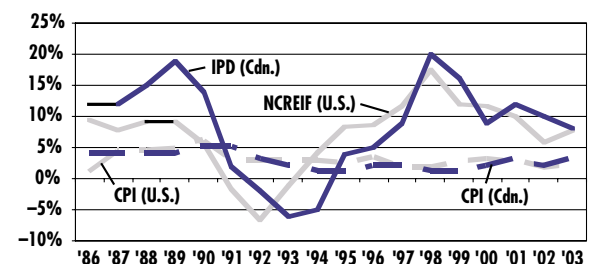
Exhibit 1: Canadian Asset Class Returns vs. Volatility (4Q99–3Q04)



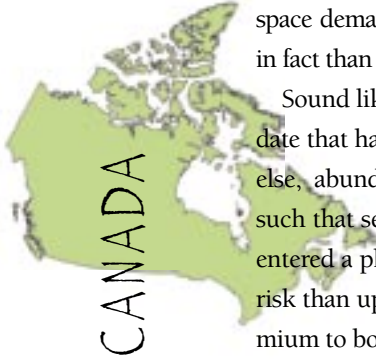
Notes: All returns in C\$. Relative size of index depicted by circle area. Investment Property Databank (IPD) returns are unlevered.

Sources: IPD, RBC Capital Markets, and Scotia Capital

Exhibit 2: Real Estate Returns vs. Consumer Price Index



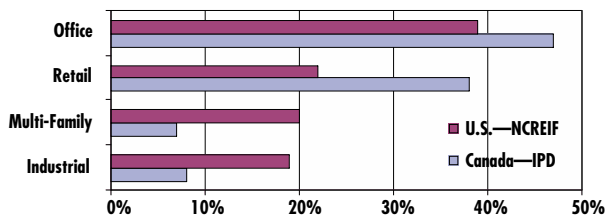
Sources: IPD and NCREIF



to recover from the trough in 1992, in part because Canadian businesses were simultaneously restructuring to compete under the recently introduced North American Free Trade Agreement and also because Canada did not have a market-clearing mechanism like Resolution Trust to reintroduce liquidity to the property markets.

Interestingly, both indices have yielded an annual income return of approximately 8 percent for the period, despite the considerably different composition of the indices (Exhibit 3). Inflation has been almost identical in the two countries.

Exhibit 3: Allocation by Property Type: Canada vs. United States



Sources: IPD and NCREIF

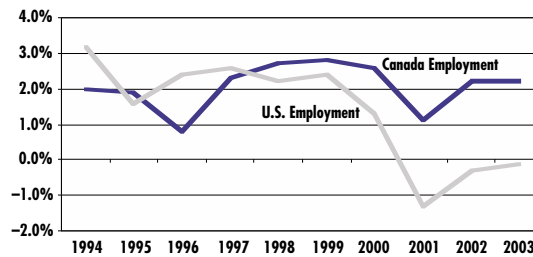
From a leasing and investment standpoint, the biggest distinction between the two countries is the relative concentration of institutional property in the six largest Canadian cities. Canada has some secondary markets, but most have comparatively small populations and are relatively remote by U.S. standards. Liquidity and leasing demand in all categories, save apartments, diminishes considerably outside the largest cities. Given this constraint, the investible institutional universe is well known to the larger domestic players and is largely made up of properties in Ontario.

Despite their traditionally tight correlation, the performance of the Canadian and U.S. economies began to diverge in 1999, and annual Canadian GDP growth averaged 15 percent over the U.S. measure in following years. The performance of the Canadian property markets followed suit.

Canadian GDP, with relatively less emphasis on the high-tech sector, grew less robustly in the late 1990s but outperformed the U.S. economy from the third quarter of 1998 to the second quarter of 2003. In large part, this was because the tech implosion of 2000 was buffered in Canada by continued strong manufacturing, particularly of autos and exports, as

well as the emergence of strong global energy and commodity demand.

Exhibit 4: Employment Growth



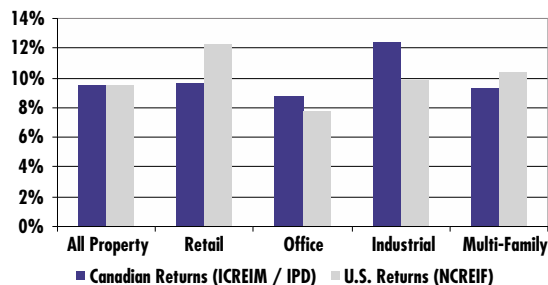
Sources: Statistics Canada and U.S. Bureau of Labor

The real story for the property markets, however, has been superior Canadian job creation since 1997. This has been partially at the expense of increased productivity growth, yet the Canadian economy has continued to create jobs at a pace considerably greater than the United States has (Exhibit 4). Corporate Canada did not experience the downsizing seen in many U.S. corporations from 2000 to 2003. As a result, five-year (to 2004) office vacancy rates in Canada have averaged 9.3 percent, approximately 5.5 percent less than in the United States.

Vacancy rates in the multi-family rental sector have always been considerably lower in Canada, in large part because of rent controls in many provinces that inhibit new construction. Vacancy rates have been generally below 5 percent in better-quality retail assets, particularly food-anchored retail strip centers.

The star property sector from 1999 to 2004 has been the Canadian industrial/warehouse sector (Exhibit 5). During this period, the vacancy rates in Canadian industrial portfolios averaged 4.4 percent, less than half those seen across the United States. High industrial occupancies have held relatively steady for the past five years.

Exhibit 5: Real Estate Returns (4Q99–3Q04)

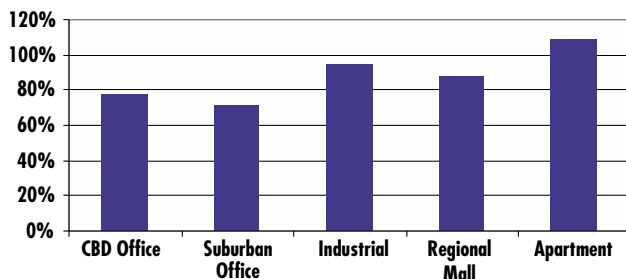


Sources: IPD and NCREIF

Interestingly, core portfolios in both the United States and Canada yielded approximately 9.5 percent during the five-year period to September 30, 2004. The returns from each property type were similar, although retail property appraisals in the United States have more closely tracked the pricing seen in recent transactions on both sides of the border, resulting in higher recorded retail yields in the United States. By contrast, higher occupancy levels have resulted in a return premium for Canadian industrial properties relative to those in the United States.

Office demand has clearly contracted in Canada over the past four years. Yet minimal distress has occurred in spite of sharply lower net effective rents, as landlords have been well capitalized and able to renew financing at much lower interest rates, and new office construction did not create imbalance.

Exhibit 6: Canadian Rental Rates
Actual 2004 NERs* vs. Real 1990 NERs (% ±)



Sources: Royal LePage and CMHC
* Net effective rents

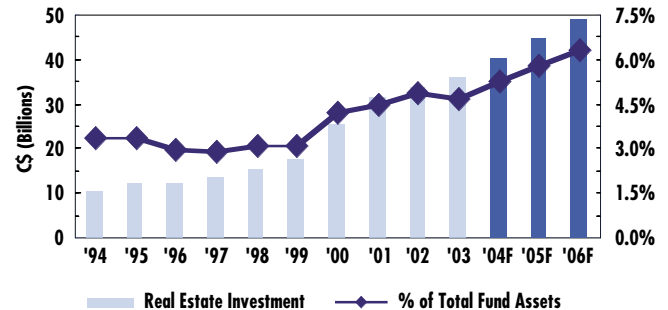
As can be seen in Exhibit 6, rental rate growth in all sectors except apartments did not keep pace with inflation from the peak of 1990 to 2004. Rents did rebound in the late 1990s after the trough of 1991 to 1994 but still not enough to get back to 1990 levels in real dollars. This was the primary reason major new construction did not occur in most Canadian markets from 1998 to 2004.

Capital Flows and Investment Returns

Two important outcomes have occurred in response to the recent market dynamics. Many large Canadian pension funds decided to increase their allocations to real estate, and many other smaller funds took their lead from successful larger funds, establishing real estate allocations for the first time. Total Canadian pen-

sion fund equity invested in real estate doubled from \$17 billion (figures in C\$) in 1999 to \$36 billion by 2003 (Exhibit 7).

Exhibit 7: Canadian Pension Fund Investment in Real Estate
Forecast



Source: Canadian Pension Fund Directories

This \$36 billion of pension fund equity compared to \$23 billion of combined total market cap for all Canadian REOCs and REITs at the end of 2003. Yet in spite of this unprecedented surge in pension fund property investment, the gap between the actual and the targeted level of property investments widened. We estimate that current pension fund allocations exceed actual equity invested by approximately \$13 billion, representing an additional requirement of one-third of the aggregate fund equity invested in Canadian property today. Some of this allocated equity may be invested in income-generating alternatives such as infrastructure, but for the moment, domestic capital clearly outstrips domestic supply.

The second outcome is that many international investors who had previously looked at Canada but preferred the deeper and more liquid U.S. markets took a closer look at Canadian property fundamentals and decided to enter the Canadian market.

At the same time Canadian funds increased their acquisition activity, meaningful global capital also discovered our relatively small market. Some of this non-domestic capital has come from U.S. investors, but most has flowed from Europe and the Middle East. Many of these investors have focused on property fundamentals, but some have also undoubtedly sought political stability. Others have combined real estate with currency strategy by denominating a portion of their North American investment in a com-

commodity-based currency. Thus far, the currency strategy has paid dividends. The Canadian dollar increased 35 percent from its all-time low in 2002 to reach a 15-year high versus the U.S. dollar in the fourth quarter of 2004.

Whatever the motivation, unprecedented offshore investment has lowered return expectations in the Canadian market. Current yields on new investments have dropped by 100 to 300 basis points in recent years to levels not seen since the late 1980s. Canadian investors who were initially reluctant to acquire properties at these pricing levels were routinely outbid in 2003 and early 2004 but have recently recalibrated their expectations in order to compete at these levels.

2005 Canadian Forecast

The global economy peaked in mid-2004. Numerous political and macroeconomic factors will determine how the world's largest economies respond, and Canada's economic performance will be determined by the global economic conditions that result.

On balance, the strong global demand for energy and commodities is likely to continue, although at more modest levels if China's red-hot growth slows. Continued commodity demand will favor the oil-, natural gas-, and mineral-based economies of Canada's western provinces, particularly Alberta and British Columbia. Ontario and Quebec will continue to be the manufacturing heartland of Canada, but these provinces will face challenges over the next 24 months if the Canadian dollar stays in the US\$.85 range or higher, which is the scenario many economists are currently predicting. This higher exchange rate will undoubtedly encourage Canadian firms to import productivity-enhancing machinery and equipment. However, it will likely also encourage firms to seek productivity gains through layoffs and space rationalization. Recent job growth has resulted in relatively weak productivity improvements. For the first time in a decade, export-oriented manufacturing firms will be forced to emphasize productivity. Other firms may consider expanding operations in the United States, in Mexico, or farther offshore as the benefit of a relatively cheap Canadian payroll wanes.

The Bank of Canada is firmly fixed in its pursuit of contained 2 percent inflation, leading most economists to predict moderately rising short rates over the next 12 to 18 months. The current consensus view is that yields at the short end of the curve will increase by approximately 100 basis points, from 2.70 percent to 3.75 percent by December 2005, and the 10-year Bank of Canada bond yield will trend up from 4.39 percent to 5.10 percent over this period.

Interest rate moves of this magnitude will probably not be sufficient on their own to result in significant loss of value in the property markets. Most of the segments will likely see reasonably sustained space demand, which will continue to support current income and value, but as always, this will differ by location and regional economy.

Industrial space demand in western Canada should continue to grow as a result of strong employment and energy prices. Alberta and British Columbia will likely see more positive absorption than the manufacturing-based eastern provinces, particularly if the automotive sector activity is not robust. The greater Toronto area, which is the third largest industrial market in North America, may also suffer from industrial overbuilding. The relatively low 4.5 percent industrial vacancy rate in this market has caused several large U.S. firms to begin speculative development. If industrial demand contracts because of cyclical and currency factors, the performance of this traditionally reliable market will be dampened.

The Canadian office markets are likely to be range bound for the next several years. Certain cities, such as Calgary, will see positive absorption as a result of energy sector expansion, but most office markets will experience below-historical-average absorption as the drive for corporate productivity limits headcount and office space growth. The downtown Toronto office market, which is 48 percent of the total Canadian central business district office market, is further challenged by the twin specters of inordinately high property taxes and consolidation in the banking industry. Calgary and Vancouver may each see some new office construction, but overall, this new activity is expected to be moderate.

Multi-family rental property will continue to be challenged by the affordability of home ownership,

but rising mortgage rates have already begun to slow new housing starts, and the massive first-time buyer tide of 2001–2004 is receding. Long-term immigration and demographic trends will support this segment, but the Canadian market is not likely to return to the very low vacancy rate experienced at the start of the decade. This segment has become more like its commercial alternatives and may see an upward movement in its return requirements to reflect the permanent shift to less defensive characteristics.

One of the strongest performing ICREIM/IPD segments in 2003 and 2004 has been retail, as in the U.S. NCREIF universe. The fundamentals for well-executed Canadian retail remain the strongest of the four main property categories. Looking to retail in 2005, the recent strong appreciation should level off. Well-run and distinctive retail in growing communities will continue to show strong income returns. However, some of the more marginal properties that have traded at peak multiples will face valuation risk as the “Walmart effect” rolls through Canada. Most retail categories face continual restructuring, and retail sales levels are expected to moderate going forward.

Well-diversified core portfolios are likely to deliver high single-digit unleveraged returns for 2005, consisting almost entirely of 7 to 8 percent income returns, plus very modest capital appreciation as values peak in late 2005. Individual assets will perform better or worse than the average, and leasing and management will, as always, differentiate performance. The Canadian real estate market has become more transparent, informed, and disciplined. Consequently, the cycle may well be more muted but is much closer to the top than to the bottom.

Risk Versus Return

Plateau or peak? A new era of lower returns due to low inflation or a bubble? These are the questions that Canadian investors, just like investors around the world, lie awake pondering. The answers can be

found primarily in the future of the bond market and secondarily in the new supply pipeline in each local market. Real estate must yield a risk and liquidity premium over the mid-term bond index. That premium in Canada has been unsustainably high for the past few years in a world of 2 percent inflation and 4 to 5 percent yields for long-term bonds. Abundant and mobile foreign capital has driven the Canadian premium down to still-rational levels, but any significant upward movement at the longer end of the yield curve will begin to impact capital values.

Canada remains solidly in positive leverage territory. This is the single greatest distinguishing factor from 1990. It is also the most compelling reason to hold and acquire property today. The return justifies the risk, without requirement for continued capital appreciation, as was required back in the negative leverage territory experienced during the 1980s. The margin for error, however, has substantially narrowed. A political or economic shock that causes considerably higher bond yields will lead to declining property values. Abundant new supply chasing merchant development profits will, in the face of generally anemic space demand, put downward pressure on rental income.

For investors seeking high-quality income yields, opportunities still exist in the Canadian markets. If the goal is targeted capital appreciation, opportunities are much more limited, but they still exist for those with on-the-ground execution depth. Beware the no-man's land in the middle. The greatest risk, we believe, lies with the assets on the institutional margin that offer the illusion of a 100 basis point increase in returns. These properties are being mispriced. When the flight to quality by tenants returns to haunt the space markets, as it always does, the undifferentiated assets will fall farthest and recover last. At this stage in the Canadian real estate cycle, the strategy of successful investors is an unambiguous focus on the quality of income. ■