Benefits and Pensions MONITOR Meetings & Events WEBINAR

Perspective on Canadian and U.S. Commercial Real Estate Markets in 2022

BentallGreenOak

Inflation is the "hottest, most debated macro theme right now," says Christina Iacoucci, Managing Partner and Canadian Chief Investment Officer, at BentallGreenOak (BGO). Iacoucci was joined by Phil Stone, Principal and Head of Canada Research, and Paul Briggs, Managing Director and Head of U.S. research, as they co-hosted the recent webinar 'Perspective on Canadian and U.S. Commercial Real Estate Markets in 2022'.

The first topic that the BGO team addressed was whether central banks can rein in inflation and what this means for cap rates and valuations. Stone noted how quickly, and high, central banks can raise interest rates before it takes steam out of the economy. The "high household debt levels and frothy residential housing market" means the Bank of Canada will have to take a measured approach. "At the same time, it can't decouple too much from the path of the U.S. Federal Reserve," he said.

Another question is whether rising interest rates will solve inflation challenges. Current rates are short term in nature and tied to COVID disruptions. No-one knows when this will start to moderate as there is a complex global economy with massive disinflationary forces at play – high debt levels, aging demographics, and technology. These continue to constrain any shift towards higher secular inflation.

Construction Costs

Inflation is prevalent in current construction costs, with a 26 per cent increase in single detached residential homes in 2021, giving some justification to the increase in prices for both resale and new home markets.

Briggs said, "we're seeing this in the U.S. as well." There, it is impacting all sectors by delaying construction and increasing project completion times.

The impact of higher interest rates on cap rates and valuations depends on several factors, he said. Spreads have tightened considerably in the last few months as cap rates drifted lower and bond yields have risen. But, generally, there's more room to absorb higher interest rates without negatively impacting values.

Drivers of cap rate spreads include the availability of capital as well as the expectations and quality of future income growth. Other factors include the overall risk profile of the asset, the sector, the market, and "investor appetite."

Briggs said the global market for capital and the potential direction of rates need to be considered. "It's going to be really difficult for the long end of the curve to increase considerably," he said.

However, investors are in search of yield and most investors in the U.S. would love to see real estate make up 10 per cent mark of their portfolios, said Briggs.

This, in turn, is a good rationale for adding new sectors like data centres and life sciences facilities to real estate portfolios.

"Life science is an exciting area," he said. "The amount of life science space in the United States is just 147 million square feet. It's dwarfed by the industrial sector."

In Canada, there are areas which have the pillars to grow life science facility development: talent, access to capital, and the research and academic institutions that drive the science. The missing ingredient is the modern lab space. "There's a real opportunity," said Stone. "It almost feels like we're at an inflection point right now, where you'll see many firms stepping up and starting to deliver more of that type of real estate."

Iacoucci said the defining real estate theme over the next five years will be decarbonization, as real estate currently accounts for an estimated 40 per cent of the global GHG (greenhouse gas) emissions.

Major Shifts

For Stone, this means "we're on the cusp of some major shifts that are going to play out over the next 10 years," with the ability to determine where investment capital flows.

The impact on valuations are positive for some assets, "We're going to see green premiums for buildings that are able to deliver on net zero and other sustainability measures," he said.

Achieving net-zero carbon buildings means offsetting direct and indirect emissions with renewable power generation, reducing energy demand, and using energy more efficiently.

Canada has a huge advantage as 69 per cent of its electricity is produced from renewables and 15 per cent from nuclear power, making it an attractive place to invest in.

"The U.S. is behind other places globally," said Briggs, "There's a host of other risks across its economy, but this is a big one," he said.

Briggs emphasized that it's not just about the move to net zero, it's about climate change with flooding, windstorms, and severe winter weather impacting assets in parts of the U.S. It's important that decarbonization becomes a part of every investment manager's DNA. **BPM**

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