CANADA

Perspective

2022

Moving forward, together

INSIDE

Resurgence in urban centres takes hold in 2022

Inflation, rising interest rates and the implications for real estate performance

Decarbonization rises to the forefront – the road to net zero

BentallGreenOak

5 KEY THEMES SHAPING THE YEAR AHEAD

We are optimistic for a continued economic expansion and the prospects for commercial real estate fundamentals in 2022. But there are several key risks to watch out for and investors will have to be even more prudent as they navigate the opportunities and challenges in front of them.

Our 2022 Perspective highlights 5 key themes that we think will be most influential in shaping the Canadian commercial real estate landscape in the year ahead and beyond.

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01

THE WAR FOR TALENT INTENSIFIES

01 THE WAR FOR TALENT INTENSIFIES

The war for talent has intensified throughout the pandemic and is now even more global with the rise of remote working. There is an increasing shortage of labour across virtually all industries and it's having a profound impact on real estate in different ways.

More job openings than unemployed

Job postings from Indeed.ca highlight the challenges that firms are facing in acquiring talent to grow their businesses. Even with a recent drop due to Omicron, open positions in Canada and the U.S. are more than 50% above pre-Covid levels.

In the U.S., there are now more than 10 million job openings, almost double the 6.3 million people considered to be out of work. Meanwhile, the Bank of Canada's most recent Businesses Outlook Survey indicated that nearly three-quarters of firms see labour shortages intensifying compared to 12 months ago—the highest level on record.

Labour shortages exacerbating supply-chain bottlenecks

On top of high commodity prices and shortages of critical materials, pandemic-related worker absenteeism and difficulties in retaining and attracting workers continues to reduce capacity to manufacture and distribute goods.

In particular, the shortage of truck drivers and warehouse employees is creating further delays and increasing costs for consumers.

Labour availability now the number one location factor for logistics users

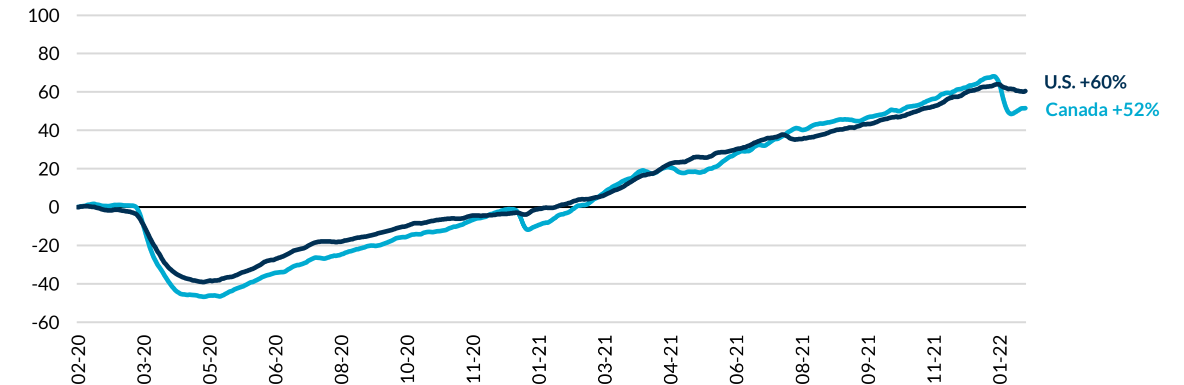
For occupiers of logistics real estate, location decisions are evaluated on several key criteria. Not only must the building specifications meet the occupiers needs to store, pick, pack and ship goods efficiently, it also must have good access to highway and rail infrastructure, and ideally be located near the end consumer.

Increasingly, however, the number one factor is whether there is an adequate employment base to staff the facility. Even with warehouses becoming more automated, picking and packing goods to ship the last mile still requires lots of human intervention.

Further downstream, retailers, bars, and restaurants – already dealing with capacity restrictions – are faced with operating skeleton crews with an absence of qualified staff. These challenges will only intensify in the year ahead if our expectations for a surge in services spending come to fruition as we discuss in the "urban core comeback."

WE'RE ALL HIRING!

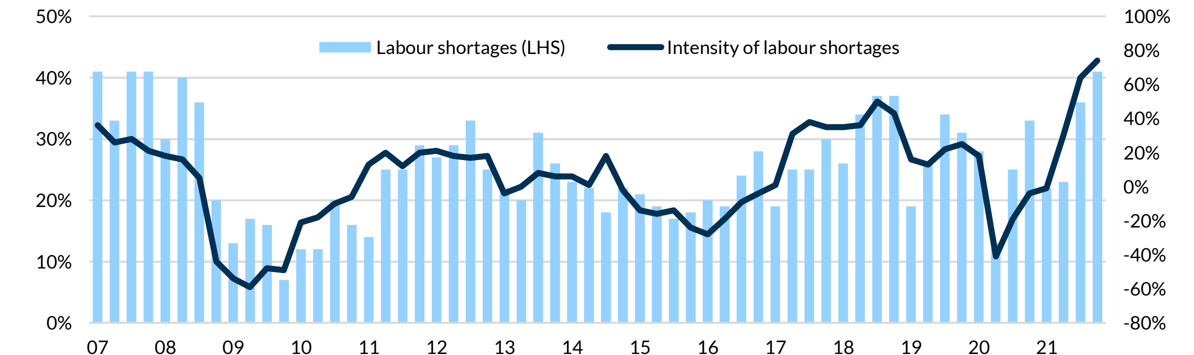
INDEED JOB POSTINGS; % CHANGE FROM FEB 1ST, FEBRUARY 2020 TO JANUARY 2021



Source: INDEED

MORE FIRMS REPORTING LABOUR SHORTAGES – HIGHEST SINCE 2007

BANK OF CANADA - BUSINESS OUTLOOK SURVEY



Source: Bank of Canada

01 THE WAR FOR TALENT INTENSIFIES

Balance of power in the hands of labour

Encouragingly office-using employment has been remarkably strong – now more than 6% or 220,000 jobs higher than pre-pandemic levels. According to employment website, Indeed, there is high demand for skills across both the innovation economy as well as more traditional roles in finance, IT, and human resources.

While we are not seeing evidence of the "great resignation" proclaimed by many U.S. pundits, these tight labour market conditions have shifted the balance of power towards employees. Workers are demanding higher wages and benefits which now include greater flexibility on how, where, and when work is done. The proliferation of remote work is encouraging everyone to reimagine what "knowledge work" looks like.

Office remains a critical talent retention tool

Although the purpose of the office is evolving, it remains a critical tool for learning, culture, and collaboration – and employees are expecting better physical workspaces that incorporate health and wellness into their everyday lives. As a result, office space will continue to be a tool for retaining and attracting talent as part of the overall employee compensation package.

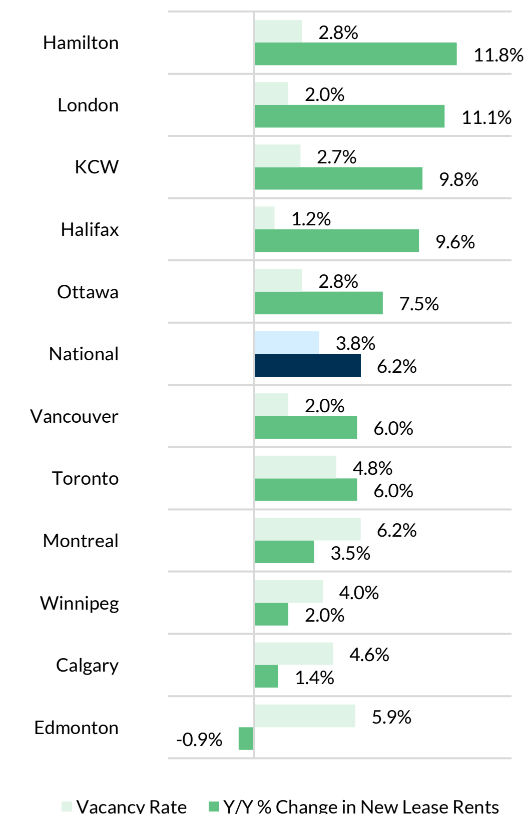
Flexible work has also enabled greater workforce mobility. The ability to work from anywhere, combined with the rising cost of home ownership has driven migration outward from city centres into suburbs and secondary markets. This has benefitted multi-res in these locations as fundamentals barely skipped a beat during the pandemic, in contrast to urban areas which saw vacancies rise.

Confidence and wage growth spurring multi-family rental demand

Although government support schemes played a role, a strong rebound in employment enabled rent collections to remain surprisingly high. Prospective renters now find themselves with improving job prospects, rising wages, and increased savings. That confidence has translated into a resurgence in rental demand in urban centres and continues to positively influence renter household formation in the suburbs. We expect strong rent growth in 2022 as many housing markets remain structurally undersupplied and overpriced.

TIGHT LABOUR MARKET BENEFITS MULTI-RES

VACANCY AND RENT GROWTH FOR SELECT MARKETS



Source: Yardi

02

PERSISTENT INFLATION AND HIGHER INTEREST RATES

02 PERSISTENT INFLATION AND HIGHER INTEREST RATES

Guidance from central bankers in early 2021 was that they were going to let inflation run hot to ensure the recovery was firmly entrenched. It's now scorching - with headline inflation in the U.S. reaching 7.0% in December – the highest year-on-year increase since February 1982. In Canada, annual change in the Consumer Price Index (CPI) for December registered 4.8% - making it the highest reading since September 1991.

Escalating construction costs in real estate

Headline inflation figures grossly understate the cost of doing business for tenants and landlords, especially as it relates to development activity.

Building construction costs increased dramatically in 2021 for all property types, especially in major markets of Vancouver, Toronto, and Montreal. Much of this is due to the reduction in capacity across supply chains brought on by successive economic lockdowns.

Price pressures are most pronounced in key construction inputs such as steel, lumber, windows, and doors. Meanwhile, higher labour costs are being driven by a shortage in skilled workers. Upward pressure on wages are unlikely to subside anytime soon given the structural shortage skilled trades, but much of health-related absenteeism will pass, providing some much-needed relief in 2022.

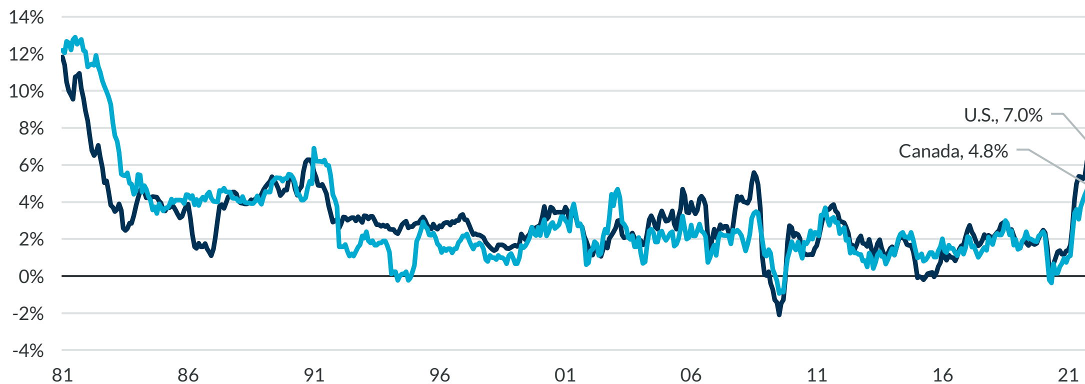
Central bank pivot

Central banks underestimated how persistent inflation turned out to be and are now forced to tighten monetary policy sooner than they were expecting. In the US, a plunging unemployment rate and soaring wage growth suggests that much of the economic slack has been eroded. The Federal Reserve kept the policy rate unchanged in January with forward guidance that multiple rate hikes will take place in 2022, beginning in March. Notwithstanding further widespread lockdowns, consensus is calling for four rate hikes in 2022.

The Canadian government has been more forceful in implementing lockdown measures compared to our neighbours to the South. As such, the economic recovery in Canada, albeit still healthy, is a step behind the US. Elevated household debt and a scorching housing market are also reasons for the Bank of Canada to proceed with caution. Nonetheless, the labour market has fully recovered all the jobs lost during the pandemic and now exceeds its February 2020 level giving the "green light" for the BoC to begin its rate hike cycle in 2022.

INFLATION SOARS TO THE HIGHEST RATE IN DECADES

% CHANGE Y/Y IN THE RESPECTIVE CONSUMER PRICE INDICES



Source: St. Louis Federal Reserve (FRED)

CONSTRUCTION COSTS SPIKE

% CHANGE Y/Y, Q4/21, BUILDING CONSTRUCTION PRICE INDEX - AVERAGE OF 11 CANADIAN CMAS

Source: Statistics Canada

02 PERSISTENT INFLATION AND HIGHER INTEREST RATES

In anticipation of a central bank lift off in 2022, longer-term bond yields have melted up, as 10-year government of Canada bonds are now yielding 1.85%, 65bps higher than just six months ago. This relatively higher yield environment in 2022 will force real estate financing rates higher. However, lending spreads will continue to face downward pressure (shock absorber) given a very competitive environment with most lenders looking to grow their programs in 2022.

Cushioning in cap rate spreads

From a borrower's perspective, although cap rates spreads have now compressed below their long-term average, there remains cushioning to absorb higher interest rates. Cap rate sensitivity to rising interest rates is largely dependent on future NOI growth expectations but the wall of capital in search of yield is also a strong tailwind for value preservation. Various institutional investor surveys over recent months have highlighted that institutions are well below their target allocation to real estate. While some of this may be self-correcting with a pullback in equity markets, we don't anticipate it will deter institutions from deploying capital as many had been sidelined for much of the pandemic. 2021 was a record year for transactions volume in Canada and we expect another exceptionally strong year with continued competition from private/high-net-worth buyers.

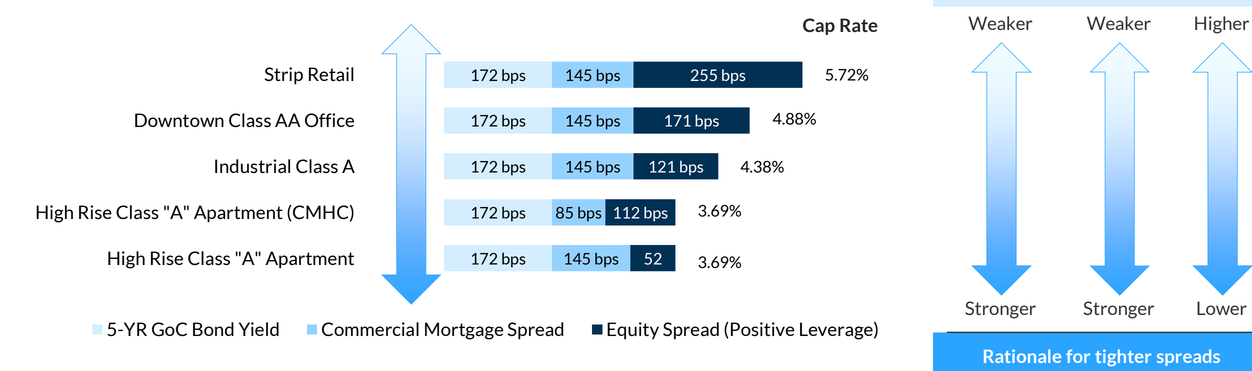
Not a perfect hedge, but a pretty good one

We recently analyzed annual Canadian real estate returns over the past 35 years under different inflation and economic growth scenarios. We found that returns tend to outperform in higher inflationary environments, especially when combined with strong GDP growth.

Commercial real estate leases often include periodic rents steps and the ability to pass on rising operating costs to tenants —two inherent inflation protections. However, pricing power must be evident through favourable demand/supply conditions which is why the outlook for multi-residential and industrial, in our opinion, is more attractive than office and retail in this higher inflationary environment. With real estate, investors should be able to sleep at night knowing the ability to grow cash flows gives them a fighting chance against inflation, particularly compared to other assets classes, such as fixed income.

REAL ESTATE SPREADS CAN ABSORB HIGHER INTEREST RATES

CANADIAN CAP RATE DECOMPOSITION BY SELECT PROPERTY TYPE



Source: BGO Canada Research, CBRE, Macrobond

REAL ESTATE OUTPERFORMS IN HIGH INFLATION AND HIGH GROWTH ENVIRONMENTS

AVERAGE CANADIAN COMMERCIAL REAL ESTATE RETURNS IN UNDER VARIOUS ECONOMIC SCENARIOS

	Low GDP Growth (First Quartile)	Medium GDP Growth (Second or Third Quartile)	High GDP Growth (Top Quartile)	**Total**
Low Inflation (First Quartile)	2.3%	8.4%	9.0%	**5.1%**
Medium Inflation (Second or Third Quartile)	3.4%	8.7%	12.9%	**9.5%**
High Inflation (Top Quartile)	5.8%	14.3%	13.1%	**10.7%**
Total	**3.6%**	**9.9%**	**12.0%**	

Source: BGO Canada Research, PREA, MSCI/REALPAC Canada Annual Property Index, Methodology: Total returns measured annually from 1985-2020; BGO Canada Research calculations; Greg MacKinnon ."What Would Higher Inflation Mean for Real Estate?" PREA Quarterly Fall 2021

03

URBAN CORE COMEBACK

03 URBAN CORE COMEBACK

“Green shoots” were emerging in city centres prior to the outbreak of Omicron. The earlier part of December was reminiscent of holiday seasons of the past with bars and restaurants near capacity and a buzz in the air. Once this latest pandemic wave dissipates, we expect a resurgence in urban centres will transpire towards the second half of 2022. The urban experience revolves around the notion of “live, work, play” and emerging trends are suggesting that the urban economy is poised to bounce back once health restrictions are lifted.

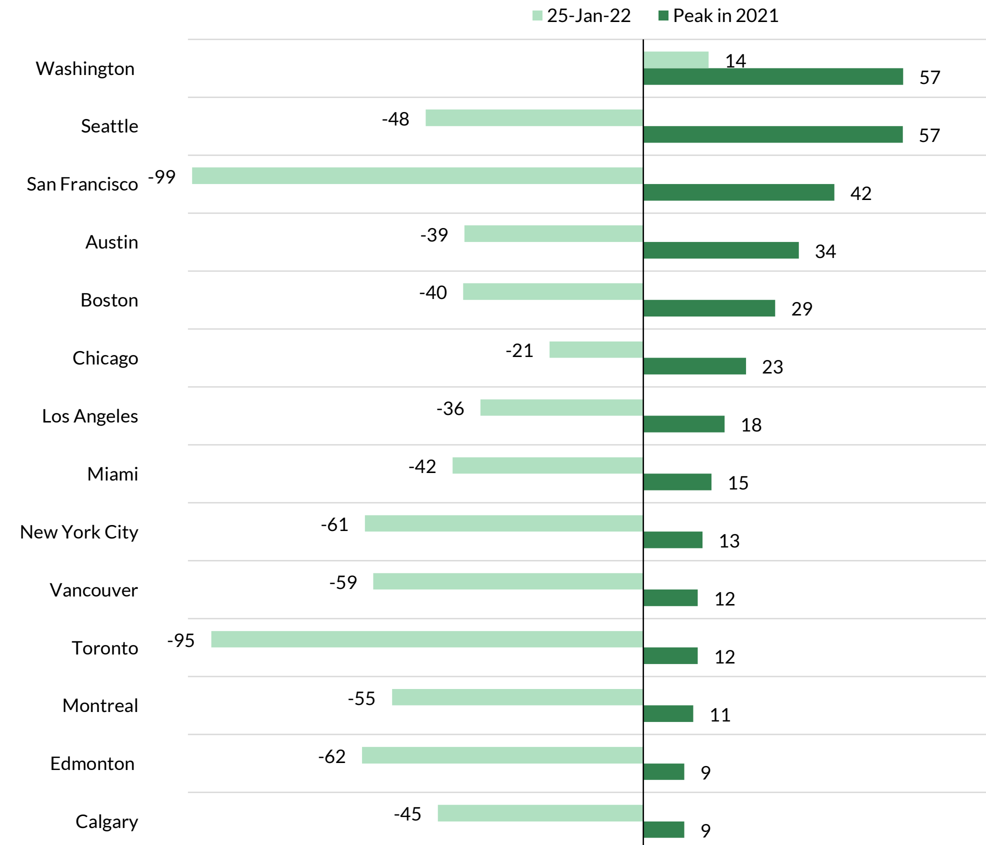
Play leads the way

OpenTable reservation data highlights the strong correlation between mobility with discretionary spending. Households demonstrated an eagerness to “play” following successive waves of COVID. With regards to in-person dining, many markets even exceeded their 2019 benchmarks in 2021.

Unfortunately, Omicron has sent people back into hiding as in-person dining dropped off significantly from the peaks in 2021. As restrictions are eased and the weather improves unwinding of household pent-up demand will shift towards services spending, providing a boost to the urban economy.

IN-PERSON DINING SURGED ONCE RESTRICTIONS LIFTED

OPEN TABLE RESTAURANT RESERVATIONS; INDEX: 100 = 2019 BASELINE FOR ANY GIVEN WEEK

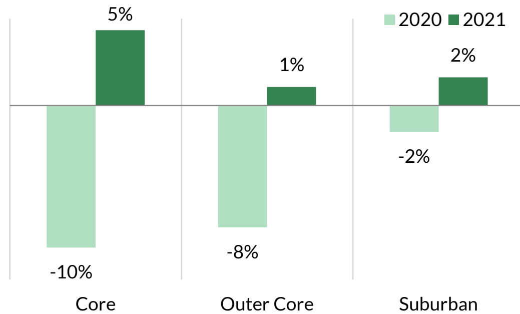


Source: OpenTable

03 URBAN CORE COMEBACK

REMARKABLE RESURGENCE IN URBAN CORE MULTI-RES RENTS

GREATER TORONTO AREA, Y/Y % CHANGE IN RENTS



Note: Core = Old Toronto; Outer Core = Etobicoke, North York, East York; Suburban = Halton, Peel, York, Durham; buildings completed after 2005
Source: Urbanation

Novus, Toronto ON

Immigration drives rental housing demand

Perhaps the most surprising story of 2021 was the torrid pace of the recovery in the multi-family rental market in urban centres. Strong lease velocity was driven by students and young professionals reestablishing roots within the core.

Meanwhile, eroding home ownership affordably and the return of immigration continue to the be the primary demand drivers over the medium term. In fact, Canada welcomed more immigrants into the country this past year than the United States despite having just a one-tenth of the population. Strong demand outpaced a robust development pipeline resulting in rising occupancy levels and strong rent growth. Despite a hiccup from Covid, we continue to invest in urban purpose-built rental as we believe in the long-term fundamentals and the resurgence of city life.

Return to office this spring

By numerous measures it's been a slow trickle back to the office for many North American markets. Even cities in the southern U.S. with much less stringent Covid measures for most of 2021, realized just 50% of 2019 physical occupancy levels at best. And when you consider it's likely that 2019 baseline levels were only 60-70% occupied on any given day, the U.S. 10-metro level peak of ~40% in December 2021 means that the average building only achieved 25% of it's physical occupancy capacity.

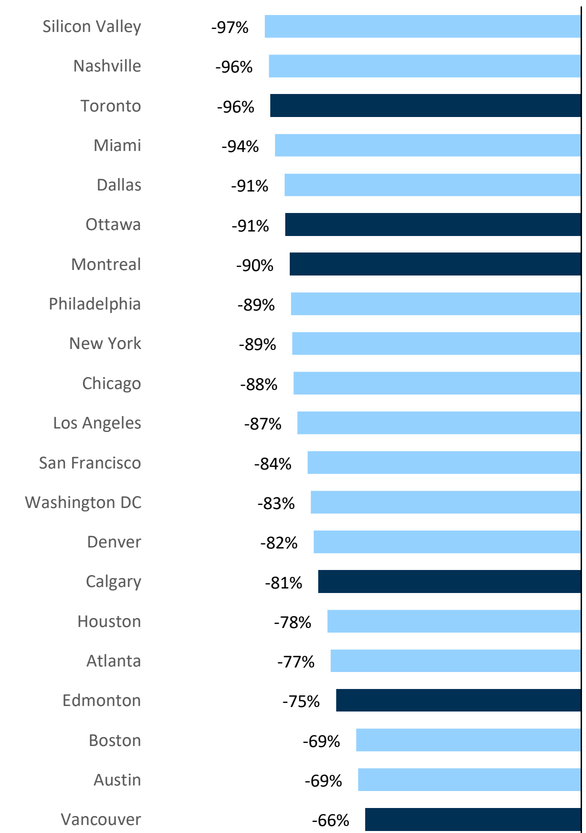
Although Omicron has pushed out the return to office plans once again, we expect that many occupiers will announce re-opening plans in the early spring and momentum should build through the balance of the year. While many firms have adopted flexible/hybrid workplace strategies, we expect a push by leaders to have teams meet face-to-face more often to re-energize culture and collaboration after the winter malaise. This should help reinvigorate urban retail and the supporting service businesses that depend on the daytime foot traffic of office users.

Carpe Diem

Each of these re-emerging live, work, play drivers should foster environments for innovation and growth in within city centres. While a rebound in business travel may never fully recover to pre-pandemic levels, we expect that leisure travel will pick up some of the slack and come roaring back. The pandemic has forced us all to reevaluate priorities and how best to spend our time and money. It would not surprise us to see both domestic and international leisure travel rise significantly this year, adding to the demand for culture and entertainment that is richest within cities.

SLOW TRICKLE BACK TO THE OFFICE

FOOT TRAFFIC AROUND OFFICE BUILDINGS RELATIVE TO PRE-COVID LEVEL (%), JANUARY 19TH, 2022



Source: Avison Young

04

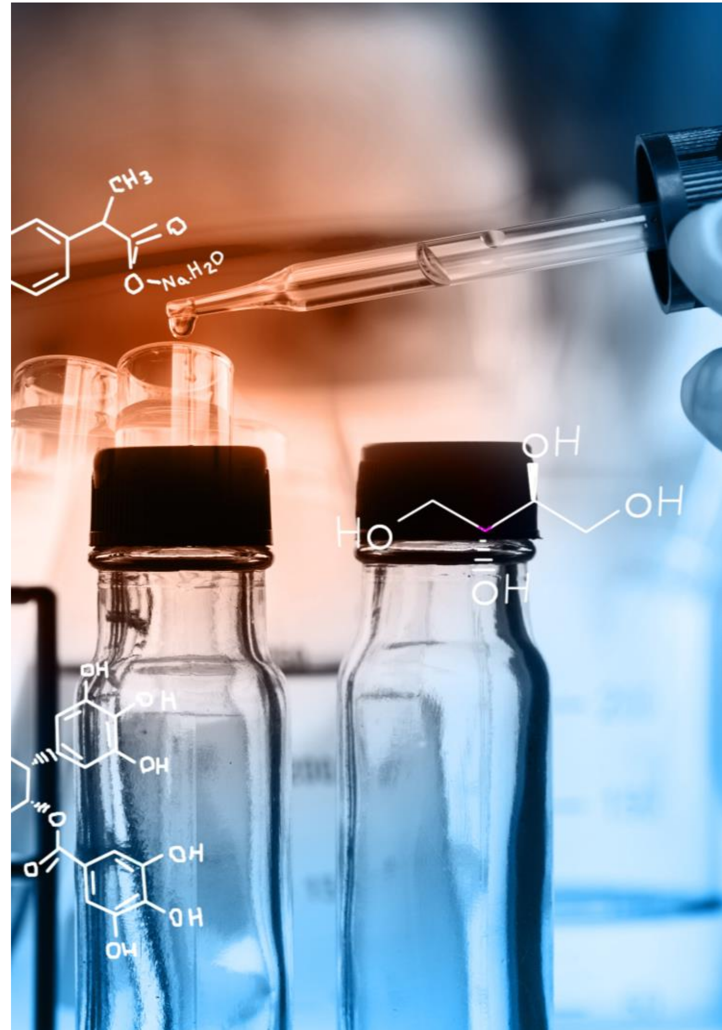
OPPORTUNITIES IN SCIENCE AND TECHNOLOGY

04 SCIENCE AND TECHNOLOGY CREATING NEW OPPORTUNITIES

Science and technology is creating robust demand for alternative real estate. But many of these nascent property sectors are dominated by the public REITs. As real estate research firm, GreenStreet, highlights, “At the beginning of this century, “core” property sectors—office, retail, industrial, and apartments—comprised 80% of the U.S REIT industry market cap. This allocation was even higher for the institutional private market.” However, core now accounts for just 40% of the REIT market and exposure in the private markets is declining. Investors are becoming more aware of the diversification benefits, income-resiliency, and higher yielding opportunities within non-traditional property types.

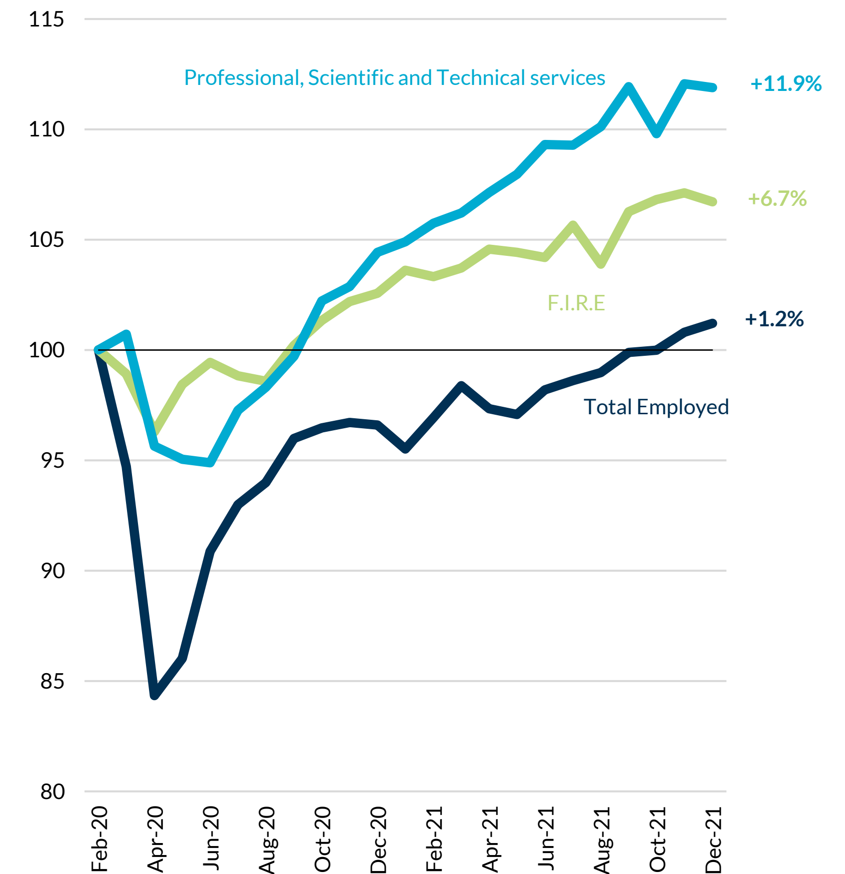
Exposure to outsized economic growth

The pandemic accelerated demand drivers particularly within Life Sciences and Data Centres. These niche sectors are even more nascent in Canada—rendering these markets anywhere form 5-10 years behind the U.S. The pandemic has illuminated the real estate that houses the industries that are generating above average economic growth. Incredibly, after a short-lived contraction in professional, scientific, and technical services employment, job creation has outpaced all other industries and is now 12% beyond pre-pandemic levels – more than 180,000 jobs!



SCIENCE AND TECH SERVICES OUTPACING OVERALL JOB GROWTH

CANADIAN EMPLOYMENT; INDEX: FEBRUARY 2020 = 100



Source: Statistics Canada

04 SCIENCE AND TECHNOLOGY CREATING NEW OPPORTUNITIES

Emergence of life sciences real estate

The convergence of science and technology (cloud, AI, compute power) has opened the door for accelerated innovation in biotechnology. Look no further than the speed at which Covid-19 vaccines were developed and produced. Add in the "silver tsunami" that has money to spend on "healthspan" and you have a robust underpinnings for growth. These tailwinds have resulted in record levels of investment from both government and venture capital to fund the next big biotech breakthrough.

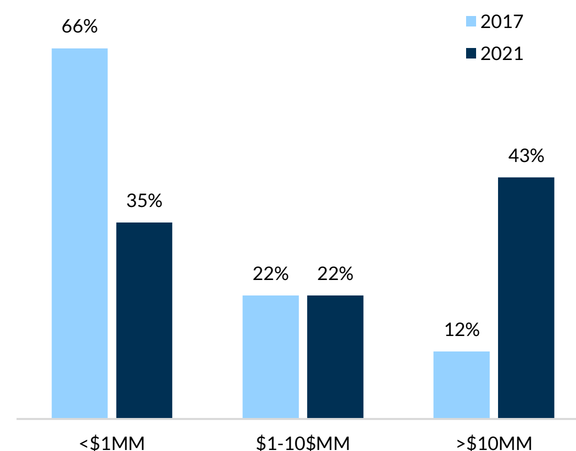
To foster this industry's growth, life science innovation clusters are blossoming. Leading clusters in the U.S., such as Boston-Cambridge, San Francisco, and San Diego have experienced strong occupancy and rent growth in recent years. Meanwhile emerging markets such as Seattle, Houston, and Austin are attracting more and more real estate investment dollars.

These clusters possess all the key ingredients for growth: 1) talent; 2) research hospitals /academia; 3) venture capital and government funding; 4) the presence of established global pharma and biotech firms; and critically 5) Lab/R&D, and manufacturing space to house this innovation.

The leading life science clusters in Canada are in Vancouver, The Greater Toronto/Hamilton Area, and Montreal, but in many instances the key missing ingredient for growth is the lack of modern lab space. With headwinds in traditional office, we expect that investors will be looking to diversify their office exposure to these high-growth drivers which also offer greater income-resiliency through business cycles.

MORE INVESTMENT CAPITAL FLOWING INTO BIOTECH

CANADIAN VENTURE CAPITAL RAISED AND PROJECTED



Source: CBRE, Deloitte Biotechnology Industry Data Survey

04 SCIENCE AND TECHNOLOGY CREATING NEW OPPORTUNITIES

Data centres empowering the digital age

The robust demand outlook for data centres (DCs) revolves around the exponential growth of our data footprint and the growing need for IT outsourcing and cloud adoption. Data has become an essential service just like power, food, and water. This secular demand story is at various stages of maturity across the global markets but it's relatively nascent in Canada where there is plenty of upside potential. Institutional exposure to DCs in Canada is in the early innings compared to the US. But this gap is quickly closing due to the strong fundamentals and attractive attributes inherent within some major Canadian markets.

Toronto is a diverse corporate hub and offering scale from a large and growing data footprint. With a vibrant tech ecosystem and large inventory of enterprise owned data centres, it is an ideal entry point for operators and investors looking to expand quickly into Canada through portfolio acquisitions and sale leasebacks.

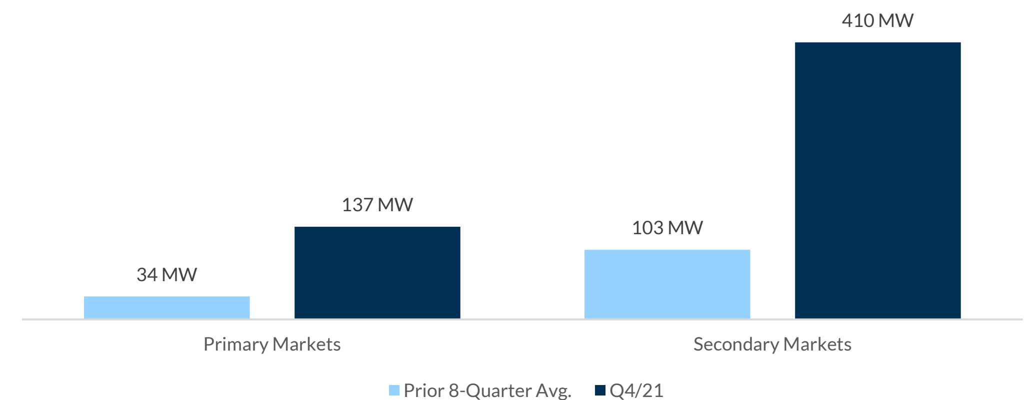
Montreal has the lowest electricity costs in North America with most of its power generated from renewable sources. This is a key competitive advantage given how energy intensive data centre operations are. Additionally, generous tax incentives for foreign tech companies and clean energy development continues to attract large tech tenants and data centre operators.

The pandemic induced a greater reliance on cloud technology to connect a dispersed workforce and enabling many to perform their jobs remotely. Together with emerging technology such as autonomous vehicles and artificial intelligence, the need for low latency data servicing should continue to bolster demand for server space within top tier data centres in 2022 and beyond.

According to leading data centre analytics firm, datacenterHawk, Q4/21 absorption was nearly 4x the prior eight-quarter average in both primary and secondary markets across North America. If the fourth quarter of 2021 is any sign of what's to come in the year ahead, we should expect the balance of fundamentals to tilt further towards owners and operators.

NORTH AMERICAN DATA CENTRE LEASING ACTIVITY SOARS TO NEW HEIGHTS

Q4/19 TO Q4/21 ABSORPTION (MW)



Source: datacenterHawk

04 SCIENCE AND TECHNOLOGY CREATING NEW OPPORTUNITIES

Acceleration of ecommerce

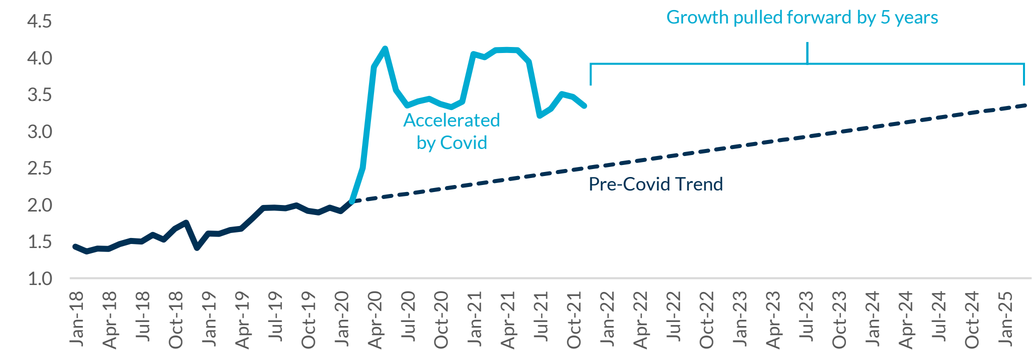
We've witnessed step-function growth in ecommerce spending throughout the pandemic. It's effectively pulled-forward five years of growth. And while 80% of core retail sales still occur within brick-and-mortar, consumer purchasing habits have been permanently altered and there is further runway for online growth.

As a result, demand for modern warehousing has surged and many Canadian markets have effectively run out of space with vacancy rates less than 1%. Advances in automation, greater clear heights (volume), could potentially shift the trajectory of future demand but we're a long way off a balanced market. It's increasingly challenging to find serviced land and we may be reaching a capacity limit on how much industrial real estate can be delivered in any given year with a shortage in skilled trades.

While retail has felt the brunt of this shift online, well-located shopping centres with strong demographics will find themselves being reintegrated into this evolving supply chain. Current zoning laws make logistics uses more challenging in these centres, but we expect that greater flexibility is on the horizon and the retail store will become an even more critical solution for the last mile, particularly when it comes to reverse logistics.

STEP-FUNCTION GROWTH IN CANADIAN ECOMMERCE SALES

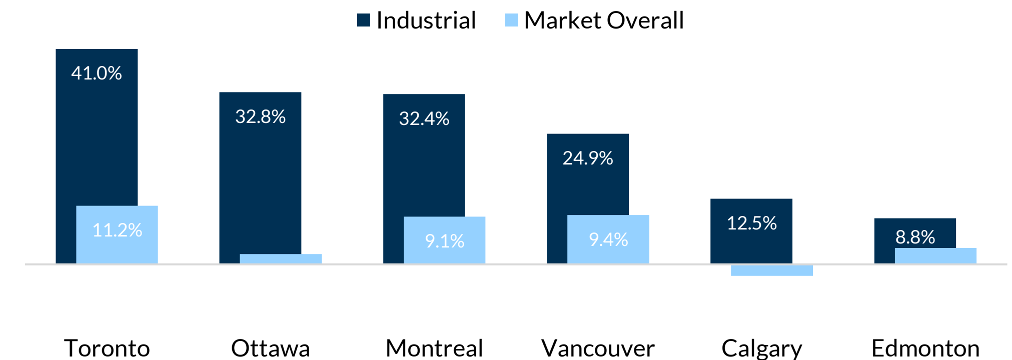
$ BILLIONS



Source: Statistics Canada

INDUSTRIAL RETURNS IN 2021 WERE THE HIGHEST ON RECORD

TOTAL RETURN, 2021



Source: MSCI/REALPAC Canada Property Index

05

DECARBONIZATION: THE ROAD TO NET ZERO

05 DECARBONIZATION: THE ROAD TO NET ZERO

Stakeholders frontrunning regulation

If not the defining real estate theme for 2022, “decarbonization” will undoubtedly be the one that defines the balance of the decade. In order to adhere to the goal of the Paris Agreement—limiting future global warming to 1.5 degrees Celsius over pre-industrial level by 2050—there will need to be a monumental shift in how buildings are operated and constructed.

Net zero targets have now been set by countries, industries and companies representing 90% of global GDP. Of the 2,000 largest public companies in the world, more than 600 have net zero strategies. But the effectiveness of such pledges will depend on the details—meaningful action—and not just “greenwashing”. BGO has joined the Net Zero Asset Managers initiative, which commits the company to achieving Net Zero GHG emissions by no later than 2050 for its entire global commercial real estate investment portfolio.

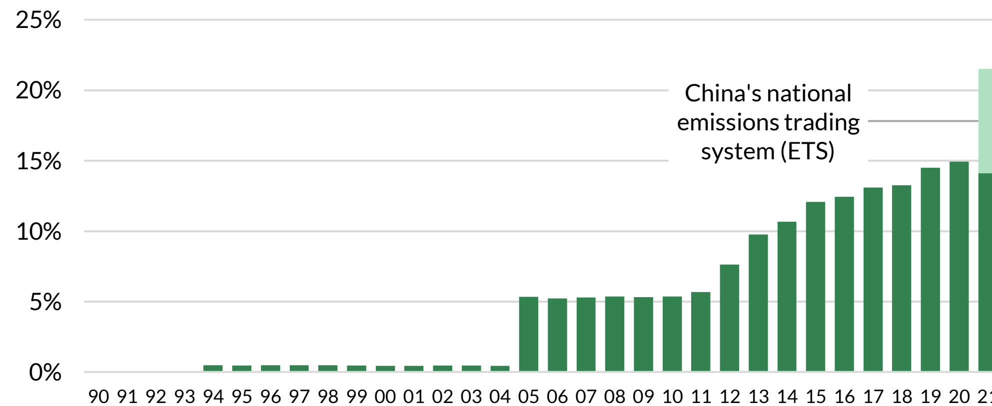
We are now in the process of developing an interim target and ensuring that this goal can be achieved through a combination of direct action and quality carbon offsets (wherever there are no viable alternatives to eliminate emissions).

To achieve this goal, our strategy is being developed through a combination of both top-down and bottom-up approaches. We are looking to understand what it will take to achieve net zero by initially developing a portfolio-level decarbonization roadmap.

Once established, a bottom-up evaluation is taken at each of our existing assets to develop a carbon transition action plan to reduce emissions over time, optimizing equipment renewals with the capex strategy for the asset where possible.

It’s encouraging to see that investors, occupiers, consumers, and employees are all demanding action towards decarbonizing in the built environment ahead of government regulation.

Europe is leading the way from a regulatory perspective. The percentage of global GHG emissions covered by taxes or carbon exchanges jumped from 15% to more than 20% in 2021 with the introduction of China’s emissions trading system (ETS).



Source: Our World in Data

05 DECARBONIZATION: THE ROAD TO NET ZERO

While North America lags, state/provincial and more local levels of government are beginning to adopt "green deals" and building performance standards. Meanwhile, the private market is collaborating and getting out in front of regulation. But with such a complex problem, oversight would be helpful in developing a global standard of measurement and disclosure.

Accelerated obsolescence

In the wake of COVID-19, increasing ESG and tenant requirements have accelerated building obsolescence. Energy efficiency, health and well-being, and technology requirements have all been elevated, particularly in the office sector.

We are now starting to see the negative impacts on leaseability, valuations and liquidity for assets that don't meet these rising expectations. Building retrofits and greater capex are solutions to maintain a building's competitive position. But many buildings could become "stranded assets" as it may be uneconomical to spend the required capex without a commensurate increase in rent to justify an acceptable yield.

However, where tenants are willing to pay a premium for quality, owners are looking at this shifting landscape as a growth opportunity and return enhancer, rather than a cost burden. Obsolescence is shrinking the investable universe which could increase the value of high-quality assets with more capital chasing a smaller pool of properties.

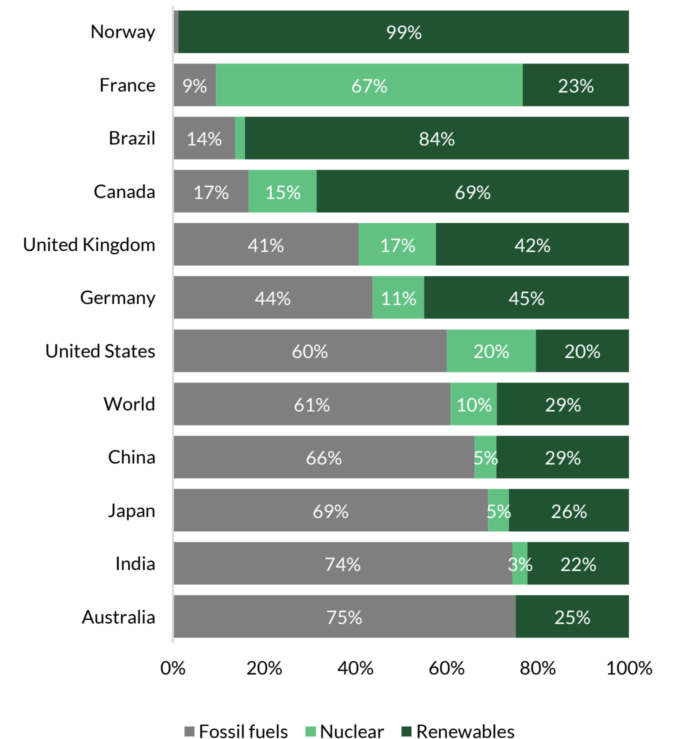
What it means for sectors, markets, and asset level portfolio construction

The risks surrounding net zero will be unevenly distributed. For example, while data centres and cold storage may have some of the highest expected returns, they are also two of the most emission intensive sectors. These may require more green capex to electrify, improve energy efficiency, and explore ways to generate renewable energy which if not offset through higher rents, could end up as a drag on returns. On the other hand, sectors such as multi-residential are lower emitting and because they provide a social good, there is likely going to be less political will to impose higher costs on them to decarbonize.

The "greening" of the electrical grid is also a key consideration. Canada is well ahead of many of its global peers, with only 17% of its electricity generated by fossil fuels and nearly 70% generated by renewables—mostly hydroelectric. In contrast, the U.S. is still reliant on fossil fuels for 60% of its electricity production. As GHG emissions are increasingly scrutinized, winners and losers will emerge among regions and capital and liquidity are likely to follow green infrastructure investment.

CANADA POWERED BY RENEWABLES

PER CAPITA ELECTRICITY FROM FOSSIL FUELS, NUCLEAR, AND RENEWABLES, 2020



Source: Our World in Data

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ABOUT BENTALLGREENOAK

BentallGreenOak is a leading, global real estate investment management advisor and a globally-recognized provider of real estate services. BentallGreenOak serves the interests of more than 750 institutional clients with approximately $70 billion USD of assets under management (as of September 30, 2021) and expertise in the asset management of office, industrial, multi-residential, retail and hospitality property across the globe. BentallGreenOak has offices in 24 cities across twelve countries with deep, local knowledge, experience, and extensive networks in the regions where we invest in and manage real estate assets on behalf of our clients in primary, secondary and co-investment markets. BentallGreenOak is a part of SLC Management, which is the alternatives asset management business of Sun Life.

For more information, please visit www.bentallgreenoak.com

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