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Real Estate Emerging from the COVID-19 Pandemic

The COVID-19 pandemic has created unprecedented challenges for real estate fundamentals in the short-term; however, three key macro-economic trends were accelerated that will increase Canadian real estate values in the aftermath.

These beneficial trends include:

1. Lower Interest Rates for Longer
2. Higher Inflation Targeting
3. Increasing Capital Allocations by Institutional Investors

Economic Background

In the dozen years following the Global Financial Crisis (“GFC”), excessive debt primarily in the banking sectors were reduced, economic confidence had been restored, and a steady growth trajectory of global Gross Domestic Product (“GDP”) was established. Additionally, world trade continued its secular rising trend representing over 60% of global GDP.¹ Many regions of the world were heralded as they experienced the longest business cycle expansion in their histories. Then in Q1 2020, the COVID-19 pandemic brought an abrupt exogenous shock to end this economic recovery. World trade was halted in its tracks and resulted in GDP drawdowns not seen since the Great Depression of the 1930s. Years of economic progress had been undone.

Economic Challenges Throughout

The global economy continues to face challenges as the COVID-19 pandemic triggers rolling lockdowns to counter

escalations in case counts. With vaccine rollout programs now underway, there is light at the end of the tunnel, but economic prospects may deteriorate in the short-term before they get better. Similar to other developed economies, in 2020 the Canadian economy severely declined by 2.1% and 11.5% in Q1 and Q2 before rebounding by 8.9% and 2.3% in Q3 and Q4, respectively.² The Q2 2020 real GDP figure of -11.5% annualizes to -46.0%, reflecting the extreme measures imposed to contain the COVID-19 pandemic such as non-essential business closures, border shutdowns, and travel restrictions. Unlike the GFC, this was a service sector-led recession. Accommodation and food services fell by 36.9% in March 2020 – the largest monthly decline on record. In contrast, transportation and warehousing contracted by only 12.2%. Inflation also dropped below 0%, signaling the deflationary impacts of the crisis. As a result of real GDP growth subsequently rebounding in the second half of 2020, inflation has bounced to 0.7% Y/Y in December 2020.

¹ [The World Bank](#)
² [Koyfin](#)



Canadian Real Estate Before the COVID-19 Pandemic

Canadian commercial real estate fundamentals had entered the COVID-19 pandemic at record strength in the industrial and multi-residential sectors. Industrial had witnessed its lowest national vacancy rates in history, benefitting from the secular e-commerce trends, especially in its large bay and distribution facility segment. Persistently rising home prices that reduced affordability for residents primarily in Vancouver and Toronto contributed to the demand for multi-residential space as much of the population in these markets had no choice but to rent. The office sector was generally stable, although beneath the surface, there was a bifurcation between downtown office

markets in primary cities and the Alberta downtown office markets. Vancouver, Toronto, Montreal, and Ottawa had benefited from low vacancy rates, strong rental rate growth, and construction activity before the pandemic, representing four of the lowest six downtown office vacancy rates in North America.³ Other downtown office markets such as Calgary had faced major fundamental headwinds that led to high vacancy and limited demand. Finally the Canadian retail sector was in a transitional state of redefining itself as tenants assessed the optimal model to operate within to either deliver a better shopping experience or efficiently deliver their goods through e-commerce channels. Unfortunately, the broader trend was resulting in a structural shrinkage in space per retailer. The COVID-19 pandemic has accelerated trends already in motion that will lead to the need to adapted operations in the future.

The Impact on Canadian Real Estate

When COVID-19 was declared a global pandemic by the World Health Organization (“WHO”) on March 11, 2020, the global economy was halted. The real estate asset class “houses” the economy; therefore, by proxy it was immediately and fundamentally disrupted.

To get a sense of the fundamental and valuation trends for each Canadian sector from Q4 2008 – Q4 2019, please see Figure 1 below. In addition, the most recent vacancy and cap rates are included, which include the COVID-19 pandemic impacts.

The key takeaway of this table is to show that the strongest sectors pre-COVID-19, were also the strongest sectors during the COVID-19 pandemic.

Figure 1: Key Canadian Real Estate Sectors’ Fundamentals

SECTOR FUNDAMENTALS	NATIONAL VACANCY RATES				NATIONAL CAP RATES (CLASS ‘A’)			
	Q4 2008	Q4 2019	Change from Q4 2008-Q4 2019	Q4 2020 (H1 2020 for Retail)	Q4 2008	Q4 2019	Change from Q4 2008-Q4 2019	Q4 2020 (H1 2020 for Retail)
Industrial	6.2%	3.0%	-3.2%	3.3%	7.4%	5.1%	-2.3%	5.0%
Multi-Residential	2.1%	2.3%	+0.2%	3.8%	6.1%	3.8%	-2.3%	3.8%
Office	6.7%	10.8%	+4.1%	13.4%	7.2%	5.4%	-1.8%	5.5%
Retail	5.3%	5.6%	+0.3%	6.8%	7.8%	6.0%	-1.8%	6.1%

Source: CBRE, CMHC

Looking Forward: Why Real Estate Will Thrive

This white paper will contend that despite the doom and gloom about disrupted fundamentals from the COVID-19 pandemic, broad values are likely to experience a surprising acceleration due to three key factors that are all economically connected.

Lower Interest Rates for Longer

Entering 2020, the Bank of Canada (“BOC”) was conflicted about changing the Overnight Lending Rate. The national inflation rate was within an acceptable range and job growth was healthy. A further rate cut might result in the housing market overheating again. However, the rapid contraction in economic activity due to the COVID-19 pandemic, combined with the oil price crash brought on by the Saudi Arabia, Russia, and OPEC+ disagreement, resulted in the BOC implementing three separate 50 basis point (“bps”) emergency rate cuts in March 2020 alone, decreasing the Overnight Lending Rate from 1.75% to 0.25%.⁴ In addition, the BOC began purchasing \$5 billion of government bonds per week and implementing the Corporate Bond Purchase Program (“CBPP”). This program supports the liquidity and proper functioning of the corporate debt market by purchasing bonds through a tender process in the secondary market. To put things in perspective, over \$18 trillion of the world’s sovereign bonds are currently negative yielding.⁵ The Government of Canada (“GOC”)

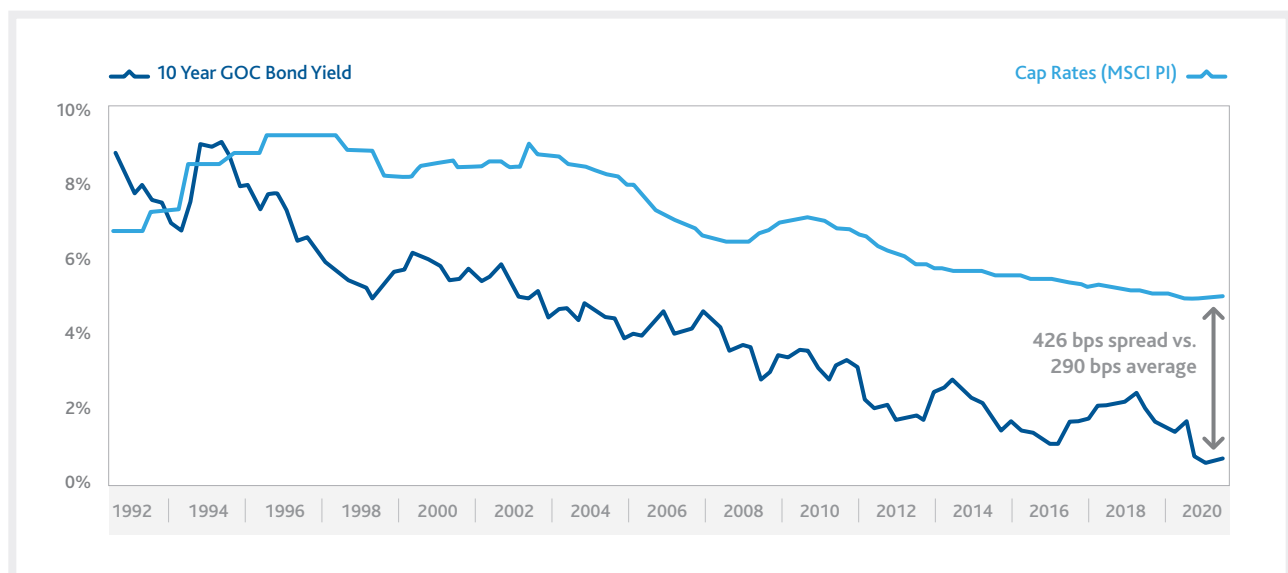
Gross Debt to Gross Debt to GDP ratio increased to 115% in Q4 2020 due to the COVID-19 pandemic.⁶ This is a level not seen since the post-World War II era.

Low interest rates are likely to persist due to aging demographics, elevated global debt levels, and deflationary forces from technological innovation. The cost of mortgage financing is a direct link to interest rates tied to the commercial real estate market. If the benchmark for mortgage pricing, GOC bond yields, and corporate bonds stay lower for longer, mortgage financing rates will remain relatively inexpensive and are likely to directly lead to falling cap rates.

Please see Figure 2 below that illustrates that there is a clear, but lagged relationship between the 10-Year GOC bond yield and Canadian commercial real estate cap rates. In fact, the current spread is historically wide.

Cap rates have typically followed interest rates and given the current spread, cap rates are expected to fall, which means increased real estate valuations – a positive for the real estate market.

Figure 2: Canadian Cap Rates vs. Government Bond Yields



Source: MSCI, Koyfin

⁴ Bank of Canada

⁵ Bloomberg

⁶ Conference Board of Canada

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Higher Inflation Targeting

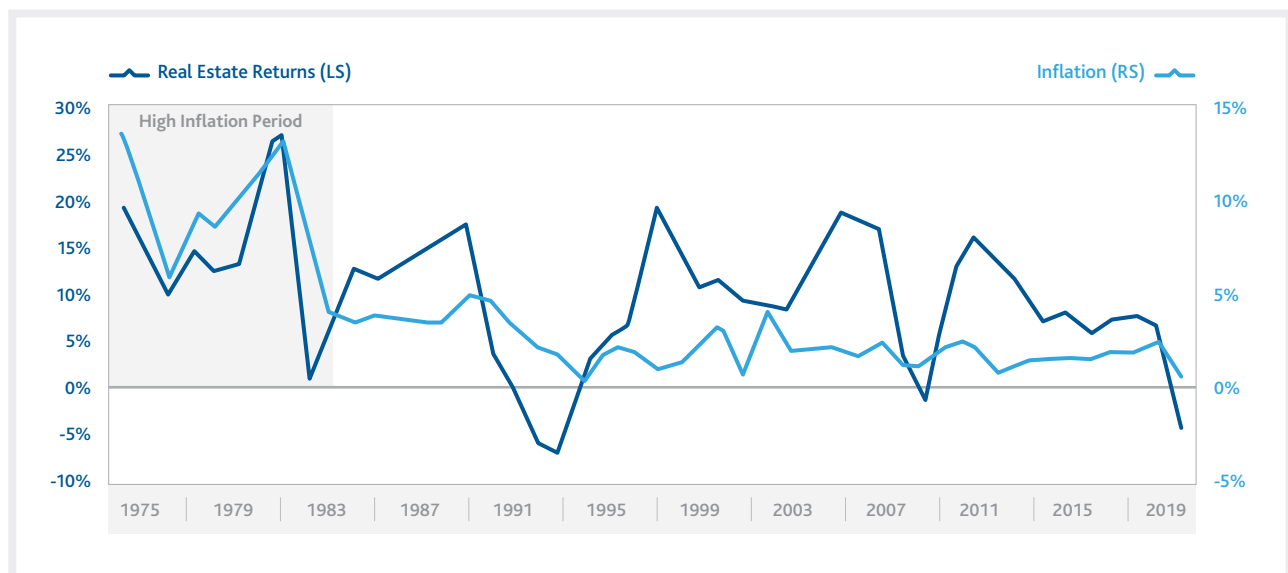
The BOC, like its US counterpart the Federal Reserve, has guided towards an average inflation targeting of 2%, which means targeting sustained inflation higher than 2% to make up for shortfalls in the years following the GFC. This tactic will help offset the debt overhangs by increasing nominal GDP. The BOC has made it evident to Canadians that they are committed to achieving this goal through examining the recent expansion of their balance sheet to counteract the deflationary economic effects of the COVID-19 pandemic. From roughly \$123 billion pre-crisis, the BOC balance sheet was expanded by over \$400 billion (19% of GDP) or an increase of 344% in just a couple of months.⁷ The drastic increase in broad money supply was needed to lend to the Government and corporations through bond purchases. This \$400 billion now sits as a liability on the BOC's balance sheet and a bank reserve asset for the commercial banking system. This means that if there is a material pick-up in credit demand, this \$400 billion of reserves can be lent and spent into the real economy and, because Canada's banking system is a fractional reserve system, it can carry a multiplier on it. Further, the COVID-19 pandemic exerted a major supply side shock on the availability of goods

and services. Given the fact that there is more credit availability and purchasing power in the Canadian banking system, if coupled with a major increase in demand, more money is likely to chase fewer goods and services. For the first time in a long time, inflation remains a real possibility. If credit demand is robust enough to begin the transfer of these funds from the banking system to the real economy, that dynamic is likely to be consumer price index ("CPI") inflationary.

Inflation is a Positive for Real Estate

Targeting higher future inflation by the BOC will increase the attractiveness of real estate as rental growth is typically inflation-linked because leases generally require rental growth be tied to inflation. Further, the intrinsic value in real estate is its land, which tends to appreciate with inflation due to its scarcity. History has proven when inflation rises to higher levels, real estate returns tend to exhibit a higher correlation to preserve purchasing power, while fixed income investments lose on a real basis, as illustrated by Figure 3.

Figure 3: Higher Inflation, Higher Correlation



Source: MSCI, World Bank Databank

⁷ Bank of Canada

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Increasing Capital Allocations by Institutional Investors

There has been an incredible shift in the last couple of decades associated with pension plan allocations between asset classes – not just in Canada, but globally.⁸ What used to be the 60/40 portfolio (i.e. 60% equities or stocks and 40% fixed income or bonds) is becoming the 40/40/20 portfolio. Alternative assets are the new 20% allocation and the largest component of this alternative bucket is comprised of real estate.

Figure 4 below exhibits the increase in sheer dollar volumes and percentage allocations to the real estate asset class, to validate this point.

Canadian pension fund allocations in absolute dollars increased by a multiple of ten from 2000-2019, representing an increasing weighting of 5.2% to 12.1% of entire portfolios. This trend of institutional investors increasing capital allocations to real estate as a percentage of their portfolios is likely to persist and increase demand and liquidity within the asset class. Institutional investors view real estate as an alternative to fixed income because unlike bonds, real estate can participate in a growing economy, offer inflation protection, and generate much higher income. With the 10-Year GOC currently yielding a mere 1.4%, it will be difficult for Canadian pension funds to reach their target returns. In addition to the return enhancement benefit, real estate also adds stability and downside protection to a traditional

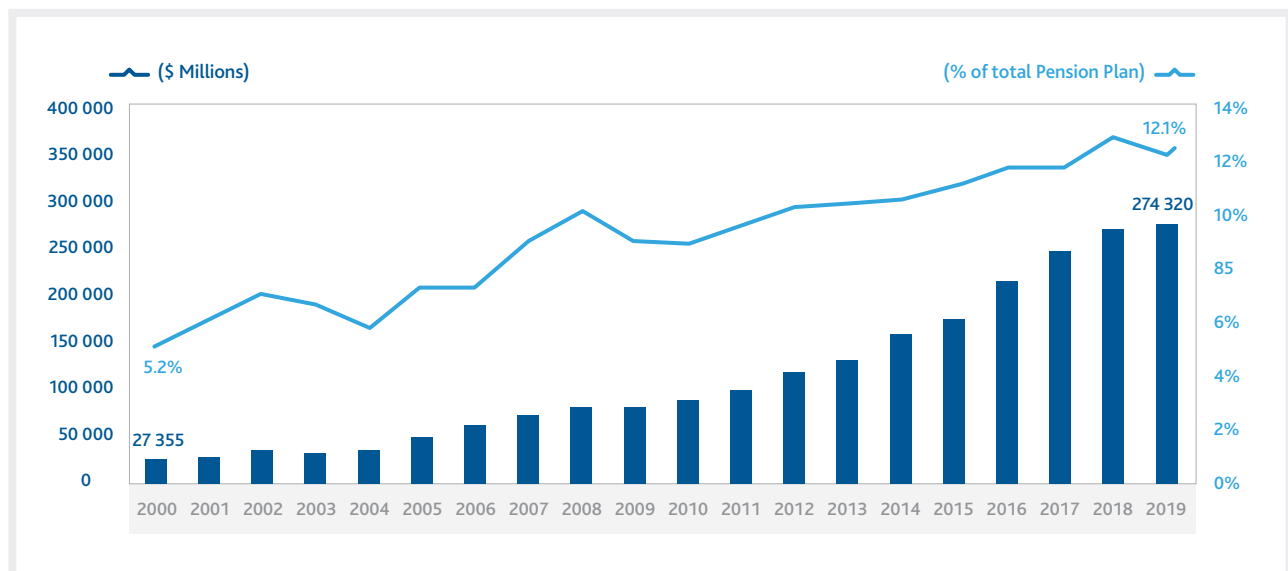
portfolio by lowering volatility due to its low correlation and diversification benefits. Pension funds recently experienced the March 2020 drawdowns in the equity markets (due to the uncertainty of the COVID-19 pandemic), which was a great example of why a stable private asset class like real estate can help diversify against volatile moves in the public markets.

Figure 5 below shows real estate's very low quarterly correlation of 0.03 and -0.06 to stocks and bonds, respectively, from Q1 1992 to Q4 2020.⁹

Figure 5: Asset Class Correlation Matrix

	Q1 1992 - Q4 2020		
	Stocks	Bonds	Real Estate
Stocks (S&P/TSX Composite Index)	-	0.12	0.03
Bonds (FTSE Canada Long Term Bond Index)	0.12	-	-0.06
Real Estate (MSCI/REALPAC Canada Property Index)	0.03	-0.06	-

Figure 4: Canadian Defined Benefit Pension Plans Real Estate Allocations



Source: Pension Investment Association of Canada

⁸ Willis Towers Watson

⁹ Fiera Real Estate – Quarterly returns correlation

Conclusion

Canadian commercial real estate will weather the storm of the COVID-19 pandemic and is expected to see sunny days ahead. The favourable macro-economic trends, that were already in place for the asset class, have been accelerated throughout these unprecedented times:

1. **Lower Interest Rates for Longer**
2. **Higher Inflation Targeting**
3. **Increasing Capital Allocations by Institutional Investors**

These three key trends should lead to broad Canadian real estate values accelerating higher in the future. Fiera Real Estate is bullish on the asset class and believes investment managers that can identify the best markets and property sectors primed for growth will hold the edge to create outperformance for investors.

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Fiera Real Estate is an entrepreneurial team working within an institutional framework, enabling clients to benefit from a unique combination of creativity and innovation supported by industry-leading expertise and investment analysis – the best of both worlds. Fiera Real Estate is a leading investment management company with offices in Canada and the UK and a team of over 130 employees. The firm globally manages \$6.3 CAD billion of commercial real estate through a range of investment funds and accounts as at December 31, 2020.

The highly diverse nature of its portfolio – in terms of both geographies and types of properties – combined with a range of best-in-class strategies provides investors with exceptional opportunities to diversify their exposure and customize their investment experience within the real estate asset class.

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