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Private Real Estate Credit as a Replacement to Traditional Fixed Income Investments

Introduction & Purpose

Investors in Canada have traditionally relied on fixed income products like government bonds, corporate bonds, and Guaranteed Investment Certificates ("GICs") for stable income returns.

However, the evolving demographic and financial landscape has led to increased interest in alternative investment opportunities. One such alternative is private real estate credit, which involves financing real estate development projects or standing assets.

This white paper describes the structural demographic and financial regulation trends leading to private credit naturally assuming a greater role in the investment arena. It also conducts a cost-benefit analysis that highlights the numerous potential advantages of investing in Canadian private real estate debt compared to traditional fixed income investments, other differentiated insights to keep in mind including the growing prominence of sustainable investing/environmental, social and governance ("ESG") aspects, as well as detailing the Fiera Real Estate platform and what solutions we can offer investors.

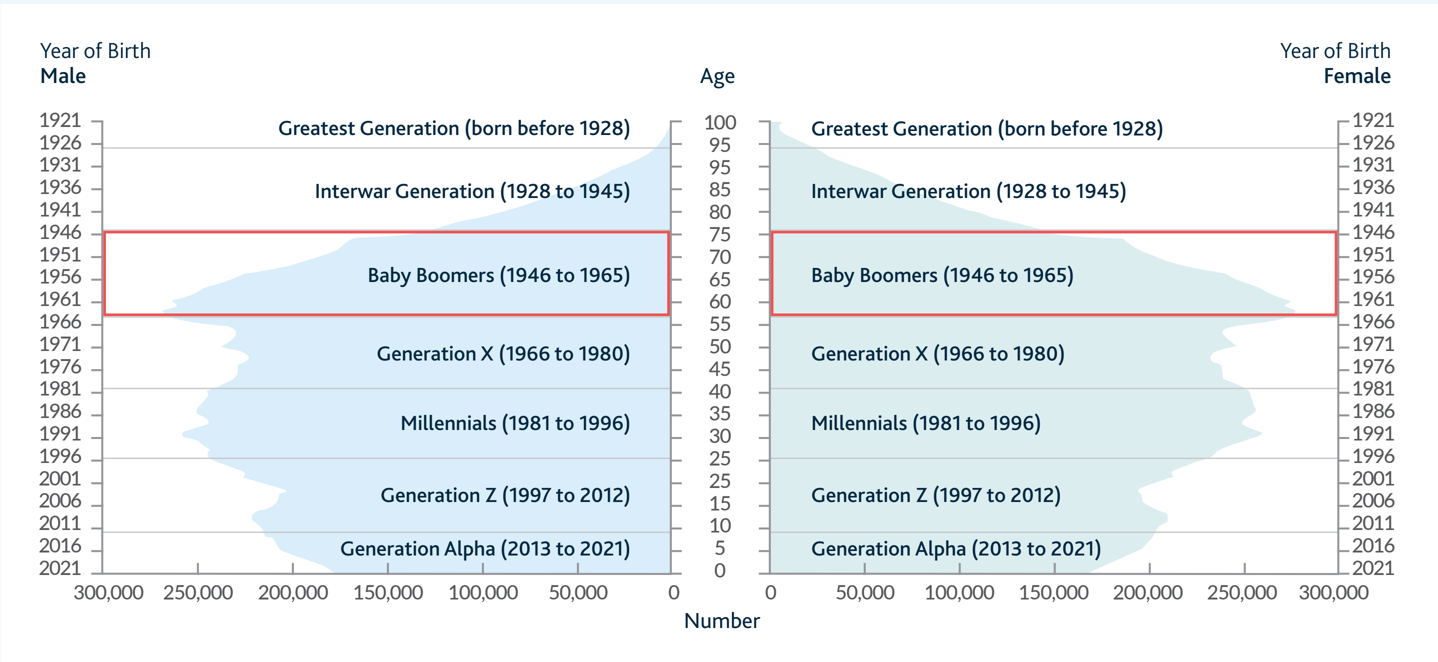
Structural Tailwinds for Private Real Estate Credit

Rising Demand: Aging Demographics are Increasing Investor Fixed-Income Demand

Canada's population is projected to continue aging significantly over the coming decades. In a medium-growth scenario, the average age in Canada is expected to rise from 41.7 years in 2021 to 44.1 years in 2043, and to 45.1 years by 2068. The proportion of individuals aged 65 and older will increase from 18.5% in 2021 to 23.1% in 2043, reaching 25.9% by 2068.[1] This dynamic is primarily driven by the Baby Boomers, a generational cohort born between 1946 and 1965.[2]

Figure 1

Age Pyramid of the Canadian Population (2021)



Source(s): Census of Population, 2021 (3901)

Over the past few decades, Baby Boomers have influenced numerous secular trends. Now, as the youngest Baby Boomers approach 60 and the oldest are 78, many are facing retirement. This shift is prompting an exodus from the workforce, heightening the need for this generation to secure stable income streams to fund their retirement. Historically, government and corporate bonds have provided solutions to this problem. However, after the Bank of Canada raised the policy rate by 4.75% from March 2022 to July 2023 — the fastest pace since the 1970s — these investment vehicles have shown vulnerabilities to rapidly rising interest rates. As a result, higher-returning and more stable options, such as private real estate credit products, may offer attractive alternatives.

Falling Supply: Basel IV is Regulating Banks into Lending More to the Public Sector vs. Private Sector

Basel IV is the informal name for a set of banking regulations known as Basel 3.1, which are part of the Basel Accords developed by the Basel Committee on Banking Supervision ("BCB") and effective January 1, 2025 in Canada, the United States and Europe. These regulations are designed to enhance the stability and standardization of the global banking system by addressing weaknesses revealed during the 2008-09 financial crisis and ensuring banks hold adequate capital against their risks. Basel IV regulations apply to banks in jurisdictions that are members of the BCBS, which consists of central banks and regulatory authorities from 45 members across 28 jurisdictions.[3]

Under Basel IV, the capital charges for holding government bonds remain favourable for global banks. The reforms focus on refining the calculation of risk-weighted assets ("RWAs") and maintaining the credibility of banks' capital ratios. Government bonds typically retain low or zero-risk weightings under the standardized approach, which means banks are not required to hold additional capital against these holdings, thus preserving their attractiveness as low-risk assets for regulatory purposes. By keeping capital charges for government bonds low, Basel IV aims to encourage banks to hold sovereign debt, which is seen as a stabilizing factor in the financial system.[4]

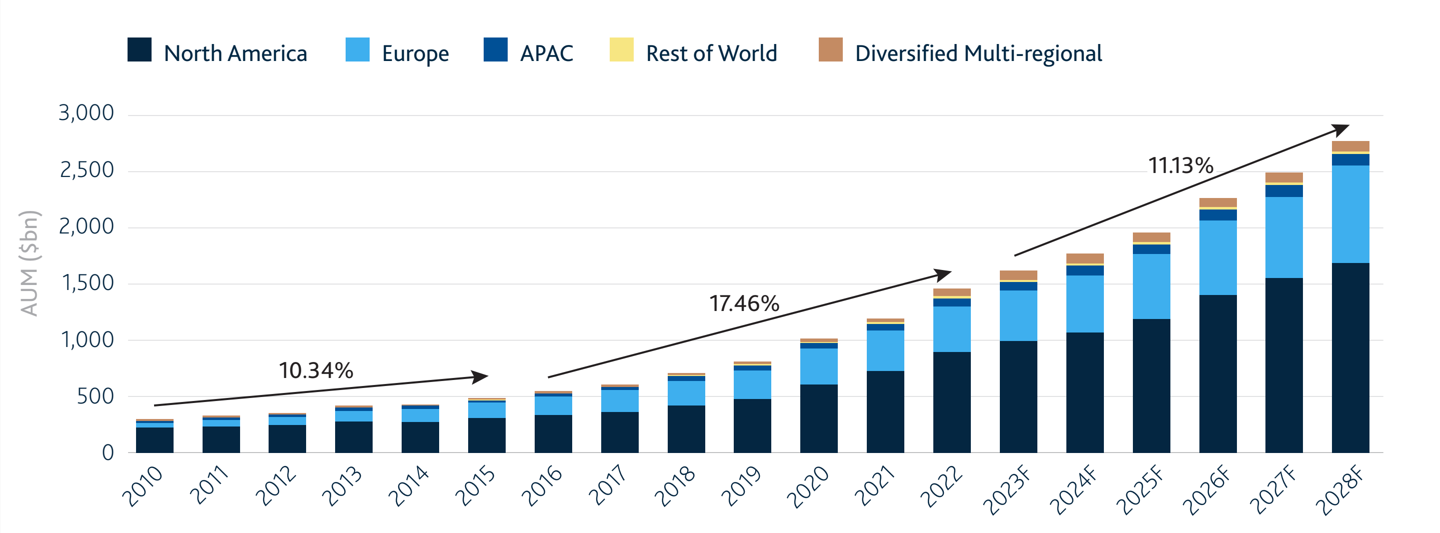
On the other hand, Basel IV increases capital charges for global banks holding commercial real estate ("CRE") loans. The BCBS has revised the standardized approach to credit risk, which now requires higher risk weights for certain categories of commercial real estate exposures. CRE loans, especially those considered high-volatility commercial real estate ("HVCRE") exposures, will attract higher capital charges. The new framework imposes more stringent requirements on banks to hold additional capital against these assets, thereby increasing the cost of holding such loans.[5]

If banks are being regulated by more favourable capital charges for lending to government rather than the private sector, a financing gap is arising that can be met by non-bank lenders. Figure 2 from Preqin's 2024 Global Report on Private Debt, shows that this has been playing out over the last decade globally and is expected to continue as non-bank lenders represented by private debt assets, continue to grow at double-digit rates. Figure 2 displays that North America represents the geography with the largest share of the assets under management ("AUM") of private debt.

Figure 2

Private Debt Asset Growth[6] — Private Debt Assets Set to Hit All-Time High

Private Debt AUM[7] by Primary Region Focus



Source: Preqin

When drilling down into Canada, according to Intellifi's 2023 Canadian Commercial Mortgage Survey, the current commercial mortgage market of C$449 billion is only 30% funded by entities classified as a "Bank," as shown in Figure 3.

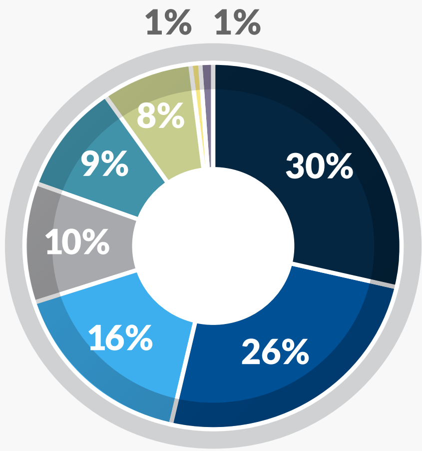
Figure 3

Canadian Commercial Mortgage Market[8]

Commercial Mortgage Market Size C$449B

By Lender Type

- **30%** Bank
- **26%** National Housing Act
- **16%** Credit Union
- **10%** Investment Manager
- **9%** Life Company
- **8%** Unsecured Debentures
- **1%** CMBS
- **1%** Other



Source: Intellifi

Overview of Private Real Estate Credit

What is Private Real Estate Credit?

Private real estate credit in Canada offers short-term loans to real estate developers for the construction of residential, commercial, or industrial properties. These loans are typically secured by the real estate being developed, providing a tangible asset as collateral. The repayment of these loans usually occurs upon the completion and subsequent sale or refinancing of the project. By facilitating the timely availability of capital, private real estate credit plays a crucial role in the development process, enabling developers to undertake and complete projects that might otherwise face financial hurdles. This type of financing not only supports the growth of the real estate market, but also offers investors an opportunity for potentially higher returns with the added security of collateralized assets.

Types of Private Real Estate Credit

1. **Land and Infrastructure Financing:** For land purchase or development, including services for residential and commercial projects.
2. **Construction Loans:** For building condominiums, multi-residential, commercial, and industrial structures.
3. **Commercial Financing:** For income properties like multi-residential, commercial, and industrial buildings.
4. **Bridge Loans:** Short-term funding until long term financing is secured or the property is sold.
5. **Mezzanine Financing:** Subordinated debt to first lien loan, but with priority over equity, allows the borrower/developer to contribute less capital.
6. **Inventory Financing:** For financing completed, but unsold units.
7. **Temporary Financing for Project Redevelopment:** For purchasing and renovating real estate assets.

Key Participants

- **Lenders:** Private individuals, institutional investors, mortgage investment corporations ("MICs"), and private equity firms.
- **Borrowers**: Real estate developers, operators and construction companies.
- **Intermediaries:** Mortgage brokers and financial advisors.

Comparative Analysis: Private Real Estate Credit vs. Traditional Fixed-Income Products

Figure 4

Risk and Return Profile of Private Real Estate Credit vs. Traditional Fixed Income

Risk & Return Profile	Private Real Estate Credit	Traditional Fixed Income
Risks	**Project Completion Risk:** Risk of delays, cost overruns, or regulatory issues affecting project completion.	**Interest Rate Risk:** Risk that rising interest rates will reduce the value of existing investments.
	Market Risk: Risk of property market decline reducing collateral value and repayment ability.	**Inflation Risk:** Risk that inflation will erode the purchasing power of fixed interest payments.
	Borrower Credit Risk: Risk of borrower default due to financial instability or poor project management.	**Credit Risk**: Risk that the issuer of a corporate bond may default on its payments.
Returns	**Higher Interest Rates:** Higher returns compared to traditional fixed income products due to higher risk.	**Lower Returns:** Typically offer lower returns compared to private real estate credit.
	Asset-Backed Security: Loans secured by the real estate being developed, providing tangible collateral.	**High Liquidity:** Many fixed income products, like government bonds, are highly liquid.
		Principal Protection: Government bonds and guaranteed investment certificates ("GICs") offer protection of the principal investment.

Main Potential Advantages of Private Real Estate Credit

Higher Potential Returns

Private real estate credit in Canada generally offers higher interest rates compared to traditional fixed income products. The typical yield on these loans today ranges from 8% to 12%+, whereas developed economies' government and corporate bonds might offer returns between 2.5% and 6%.[9] This higher yield compensates for the increased risk of real estate development projects and illiquidity.

Diversification Benefits

Investing in private real estate credit can provide significant diversification benefits. The Canadian real estate market often has low correlation with traditional bond markets, offering a hedge against market volatility and interest rate fluctuations. This diversification can help reduce overall portfolio risk.

Reduced Interest Rate Sensitivity

Public fixed income products, like government and corporate bonds, are highly sensitive to interest rate changes, which directly affect their market value. In contrast, private real estate credit, particularly construction loans, has lower interest rate risk due to shorter durations and being secured by tangible assets. These factors make them less vulnerable to rate fluctuations, offering more stability.

Inflation Hedge

Real estate, including construction projects, often appreciates over time, providing a natural hedge against inflation. Traditional fixed income products, particularly long-term bonds and GICs, are susceptible to losing value in inflationary environments as their fixed interest payments become less valuable. In contrast, the value of real estate and the returns from private construction lending tend to increase with inflation, preserving the investor's purchasing power.

Security and Collateral

Private construction loans in Canada are typically secured by the underlying property, providing a tangible asset as collateral. This security can offer additional protection compared to unsecured fixed income products. For example, with an unsecured corporate bond, the bondholders have a general claim on corporate assets, but in the event of a borrower default on a commercial mortgage or construction loan, the lender can seize and sell the property to recover the loan amount.

Flexibility and Customization

Private construction lending allows for more flexible and customizable terms compared to traditional fixed income products. Canadian lenders can negotiate interest rates, loan durations, and repayment schedules to better align with their investment goals and risk tolerance. This flexibility could result in more favourable terms and higher returns for investors.

Differentiated Insights for Canadian Investors

Understanding Regional Market Dynamics

Canadian real estate markets exhibit significant regional variation. For example, the dynamics in Toronto, Montréal and Vancouver are different from those in smaller cities like Québec City, Halifax or Saskatoon. Investors who understand these regional differences can better assess the risk and potential return of construction projects. For instance, while Toronto, Montréal and Vancouver have high property values and strong demand, they also face stricter regulations and higher development costs. Smaller cities might offer more straightforward regulatory environments and lower costs, albeit with different market risks.

Regulatory Environment & Bodies

In Canada, private real estate credit must be federally incorporated with Canada's Office of the Superintendent of Financial Institutions ("OSFI"), and is subject to provincial regulators in order to provide various protections for investors.

- **Financial Services Regulatory Authority of Ontario ("FSRA"):** Oversees mortgage brokers and administrators in Ontario, ensuring compliance with provincial regulations.[10]
- **British Columbia Financial Services Authority ("BCFSA"):** Regulates the mortgage broker industry in British Columbia.[11]
- **Real Estate Council of Alberta ("RECA"):** Governs the real estate and mortgage brokerage industries in Alberta.[12]

Tax Considerations

Understanding the tax landscape is crucial for private real estate credit in Canada. Each province has specific regulations and incentives that can impact project viability. Additionally, tax considerations such as the Capital Cost Allowance ("CCA") for depreciating property and the rules surrounding tax deductions for interest expenses can significantly affect the net returns on construction loans.[13]

The Growing Role of Sustainable Investing/ Environmental, Social, and Governance (ESG) Factors

With the spotlight now on private real estate credit, combined with increased demand from investors for sustainable investing-focused strategies, the ability of this asset class to adequately address sustainable investing considerations is under scrutiny.

Historically, real estate credit has been slower than the real estate equity investment sector with regards to sustainable investing integration, with data accessibility, as well as lack of control and influence over a building in comparison to its owner, being cited as the primary reasons for this being the case. Nonetheless, the real estate credit space plays a critical role in the built environment's decarbonization, nature restoration and social impact efforts. Lenders provide the foundations for the creation, preservation, and regeneration of our building stock and as such have a responsibility to support the sustainable transformation of the real estate sector. Increased recognition of this responsibility, continued investor pressure, improved sustainable investing maturity from borrowers – and not to mention regulatory pressures – have all led to the industry seeing a marked shift in action from many private real estate lenders. In addition to the number of managers waking up to the growing level of expectation being placed on them by investors, we are also seeing a shift in terms of what lenders are focusing their attention on. Today, the level of detail being asked for by lenders of their borrowers has changed significantly, particularly for a sustainable investing-focused fund under Sustainable Finance Disclosure Regulation ("SFDR").

Going one step further, many lenders are starting to include loan covenants that address data sharing and other sustainable investing-linked targets, as well as looking at preferential credit for those with stronger sustainability ambitions. It is clear that real estate lenders have a real opportunity to drive market transformation, but there are also clear risks and benefits associated with the integration, or lack thereof, of sustainable investing considerations. There is mounting evidence that transition risk, regulation and investor pressures may expose a significant number of real estate assets to the risk of becoming stranded. This has a direct impact on lenders, who need to be monitoring their existing and future loan book against a set of rigorous sustainable investing criteria, the extent of which extends well beyond what has previously been looked at in the past. In addition to improved risk management, there is also a great deal of value to be found in engaging with borrowers on the topic of sustainable investing.

This is particularly true in the real estate equity investment sector, where these considerations have acted as a real catalyst for improved tenant relationships. Yet the same concept applies to credit, where managers have an opportunity to create positive touchpoints with borrowers to foster better relationships, which could lead to further financing opportunities in the future, as well as to support borrowers in achieving their own sustainable investing ambitions and goals. This idea is further supported when lenders are able to provide their borrowers with incentives that encourage the operation or development of more sustainable buildings, such as preferential credit rates to meet specific sustainable investing requirements or capex opportunities to upgrade and improve buildings.

While tremendous progress has been made, real estate debt managers must re-evaluate the role they can play in the drive to transform the built environment; for time is of the essence.

Fiera Real Estate's Private Real Estate Credit Platform

The *Fiera Canadian Real Estate Debt Fund* seeks to provide investors stable returns through short-term financing investments in construction and redevelopment real estate projects across Canada. The Fund is structured as a limited partnership and operates as an open-ended fund that seeks to provide liquidity and steady income to investors from a portfolio of real estate debt investments.

Our fully integrated investment team provide flexible loan products tailored for experienced developers' covering land-inventory-to-develop, construction and redevelopment, with a focus on quality projects, which are diversified regionally and have a clear and solid exit strategy. Once funds are deployed, a hands-on active approach is maintained with projects monitored closely through to completion and exit.

As of June 30, 2024, the portfolio was 100% composed of floating-rate loans with mostly first-rank security on quality Canadian real estate. More than 70% of loans feature interest rates floors to allow investors to benefit from higher interest rate environments with protection from sharp declines in interest rates, and the fund has a 5-year average loan to value ratio of 70%.

Loan investments of the fund have a short term of 1-2 years providing the fund with agility and relative liquidity that permit rapid portfolio adjustment to help take advantage of changing market dynamics.

Typical Loan Details

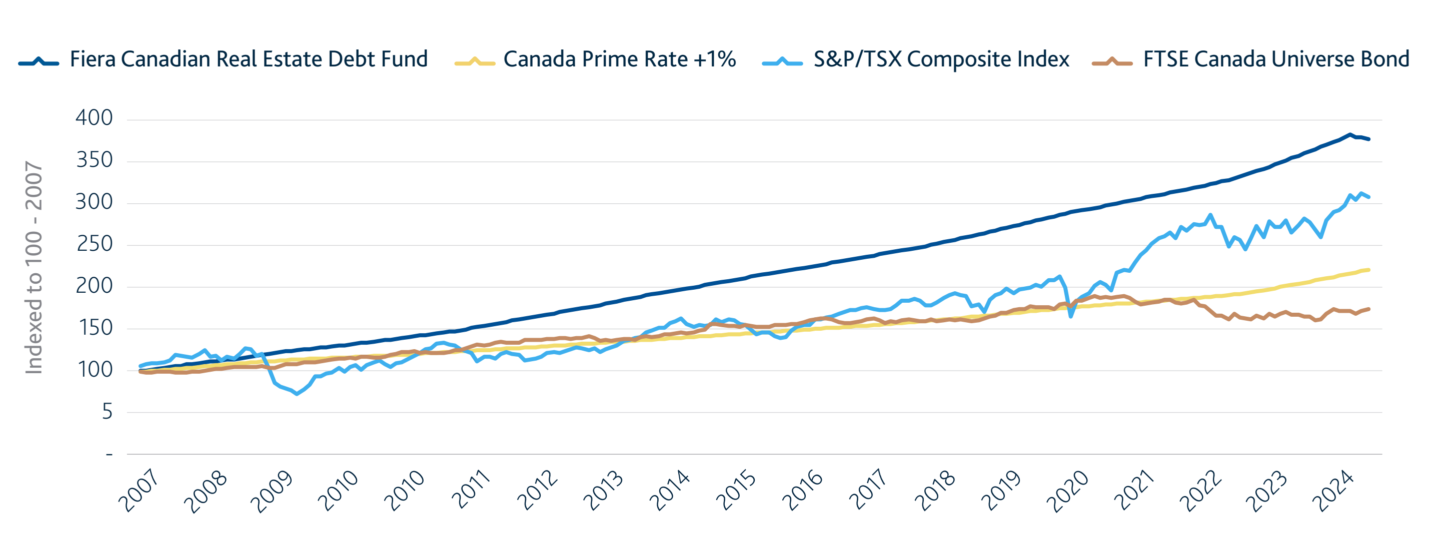
- **Size:** CA$5M-CA$50M
- **Type:** Floating rate
- **Average loan term:** 12-24 months
- **Security:** Primarily first lien, with some second lien, on quality Canadian real estate

As of June 30, 2024, the strategy has deployed $5.5 billion of loans and supported the development of more than 29,000 residential units across Canada, delivering 7.91% net annualized return inception-to-date to investors.[14 15]

Figure 5

Fiera Canadian Real Estate Debt Fund

Cumulative Performance vs. Key Benchmarks[16,17,18,19]



Sources: Bank of Canada, BlackRock, Fiera Real Estate

Conclusion

Structural trends driven by aging demographics and banking regulations are converging to create a situation where demand for higher-yielding fixed income investment products will increase, while bank funding for commercial real estate loans will decline. This creates potential opportunities for non-bank lenders, particularly private real estate credit investors, to step in.

Private real estate credit offers numerous potential advantages over traditional fixed income products for Canadian investors, including higher potential returns, diversification benefits, reduced interest rate sensitivity, inflation protection, secured collateral, and flexible, customized investment products.

However, these benefits come with increased risks that investors must carefully consider. By understanding the differentiated characteristics and potential rewards of private real estate credit, Canadian investors can make more informed decisions and seek to enhance their overall investment portfolios.

Fiera Real Estate has deep expertise in this emerging asset class and its *Fiera Canadian Real Estate Debt Fund* is designed to enhance the risk-adjusted returns for institutional and private investors seeking to add private real estate credit as an alternative to traditional fixed-income investments in their portfolios.

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14 Net returns reflect the deduction of all fees and expenses incurred by investors. Net returns reflect the deduction of [management fees, performance-based fees, expenses, transaction costs, etc.].

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