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Value-Add Investing in Canadian Real Estate

Executive Summary

Canadian real estate provides domestic and foreign investors with attractive long-term returns, low volatility and high transparency. Canada also offers a diverse economy with a stable, sophisticated and well-regulated banking and lending environment, all of which are beneficial to real estate investing. Private real estate in Canada has generated attractive absolute and relative returns over short, medium and long time horizons and it is expected to continue to do so over the long term.

This backdrop is favourable to both core and value-add investing strategies. LaSalle published a report on core real estate investing (*Investing in Canadian Real Estate, January 2017*) and in this paper we turn our attention to value-add investing. This report starts with an overview of the benefits of investing in Canadian real estate, followed by value-add strategies that are attractive in the current environment.

For investors pursuing a value-add strategy, Canada's six major markets offer distinct opportunities due their different positions in the economic, real estate fundamentals and capital markets cycles at present. Among the major markets in Canada, LaSalle considers Toronto and Vancouver to be late cycle markets, Montreal and Ottawa are in mid-cycle, while the Alberta markets of Calgary and Edmonton are early cycle. Furthermore, the office, industrial, apartment and retail sectors each have different investment characteristics with varying value-add opportunities, making the Canadian market well-positioned to generate strong value-add returns.

Late cycle markets allow investors to capitalize on lease-up strategies given low vacancy rates and opportunities to increase net operating income (NOI) due to strong market rental rate growth. Mid-cycle markets allow investors to reposition and renovate properties to make them more attractive relative to their peers. Early cycle markets allow investors to acquire assets at lower prices and capitalize on an eventual rebound in economic growth, which often prompts renewed market demand, and rising real estate rents and values.

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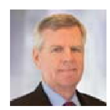

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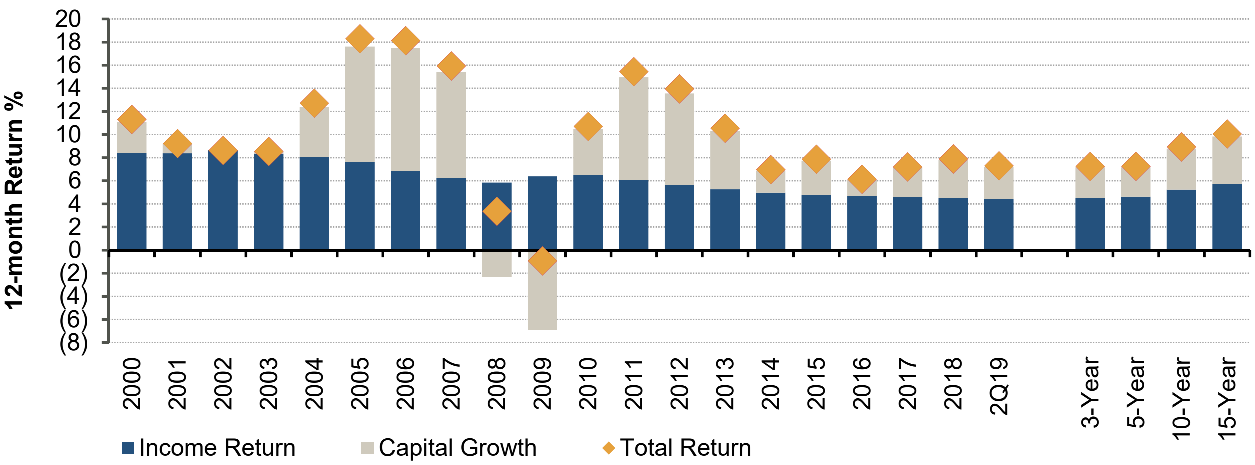
Canadian real estate has a strong track record of attractive returns with low historical correlations to other countries. Canadian real estate's income returns have historically trended at a healthy spread to bond yields, indicating attractive relative value. At the current point in the cycle, bond and real estate yields are unlikely to decline further, thus investors should focus on other return drivers; namely, cyclical opportunities such as lease-up, repositioning and build-to-core. Ultimately, the objective is to deliver strong, stable income returns, which typically account for one-third to one-half of total value-add returns in the Canadian market.

Historical Performance of Canadian Real Estate

Direct real estate in Canada owned by institutional investors has performed well over both short and long-time horizons (Figure 1). At 2Q19, annualized, all property unlevered total returns have been 7.3% over the last five years, 8.9% over the last 10 years and 9.9% over the past 20 years.[1] Returns over the 10- and 20-year periods have exceeded domestic stocks and both domestic and global government bonds, domestically and globally (Figure 2), and compare well with U.S. direct real estate as measured by the

Figure 1: MSCI Canada Quarterly Property Index Annual Returns, All Assets Basis



Source: MSCI / REALPAC Canada Quarterly Property Index at Q2 2019.

Figure 2: Comparative Historical Returns at 1Q 2019

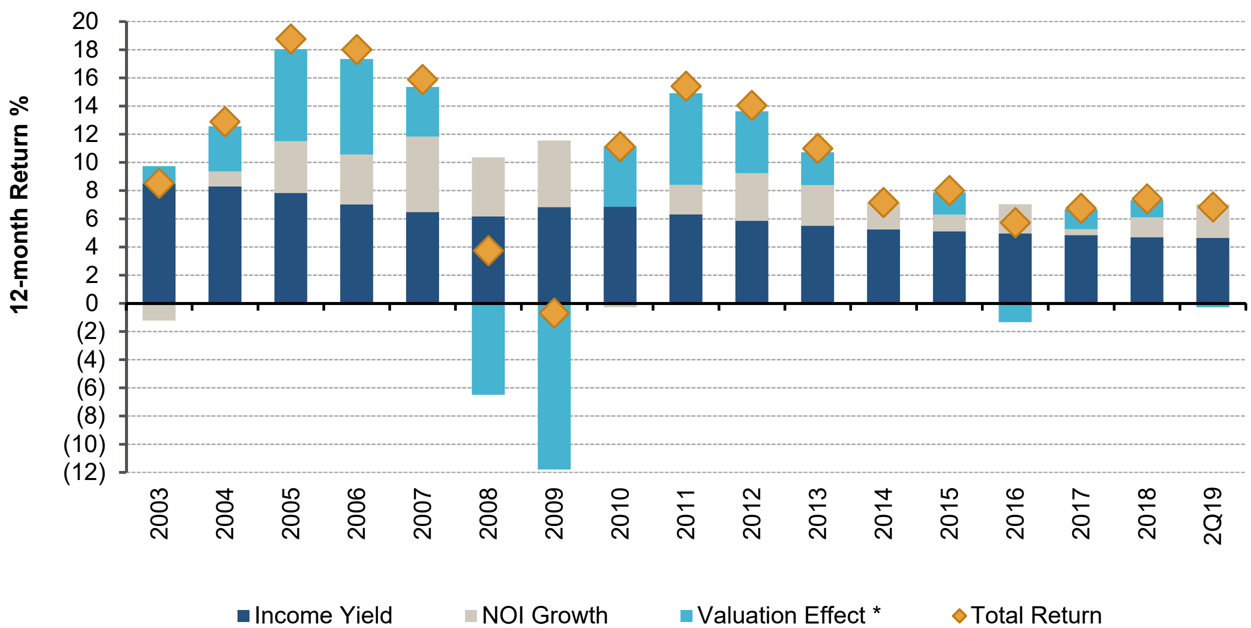
Average Annual Returns	Canada Direct Property (MSCI)[1]	Canada Property Fund Index (MSCI PFI)[2]	Canada Stocks[3]	Canada Bonds[4]	Global Stocks[5]	Global Gov't Bonds[6]
1 Year	**7.3%**	**7.6%**	**3.9%**	**7.3%**	**7.3%**	**6.1%**
3 Years	**7.3%**	**7.9%**	**8.4%**	**2.5%**	**12.6%**	**1.3%**
5 Years	**7.3%**	**7.1%**	**6.2%**	**3.6%**	**8.8%**	**3.2%**
10 Years	**8.9%**	**8.4%**	**7.8%**	**4.2%**	**11.9%**	**3.5%**
20 Years	**9.9%**	**n/a**	**6.8%**	**4.8%**	**5.0%**	**4.0%**

Sources:
1. MSCI / REALPAC Canada Quarterly Property Index – Unlevered All Property total return in $CAD
2. MSCI / REALPAC Canada Quarterly Property Fund Index – Fund level gross total return in $CAD
3. S&P/TSX Gross Total Return Index
4. iShares Core Canadian Universe Bond Index (XBB) – Total return
5. MSCI All-Country Gross World Total Return Index (GDLEACWF) in local currency
6. Citigroup World Government Bond Index (SBWGL) – Total return

NCREIF Property Index (NPI), which has had average annual returns of 9.2% over 10 years and 8.9% over 20 years.[2] Shorter term real estate returns have also outperformed, measured in both the MSCI Canada Quarterly Property Index and the MSCI Canada Property Fund Index (Figure 2), and also often exceed the CPI+4% or 5% range real estate investors typically seek. Since 1978, direct unlevered real estate returns in Canada have exceeded CPI inflation by an average of 6.8% per year, exceeding 4% or more 70% of the time.[3]

Canadian real estate's strong historical performance has been driven by strong income returns and NOI growth, but also by cap rate compression. Cap rate compression was most pronounced from 2005-2007 and 2011-2012 and has continued at a slower pace for most core assets to 2019, as capital continues to pursue Canadian real estate investments.

Figure 3: Components of MSCI Index Annual Returns



Source: MSCI / REALPAC Canada Quarterly Property Index at Q2 2019. *Valuation effect, or residual capital growth, is measured as capital growth minus NOI growth. Returns are on a standing investments basis.

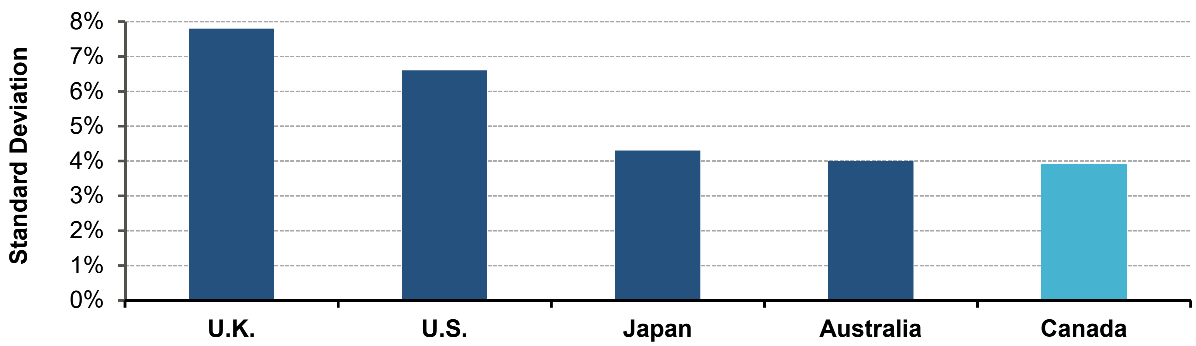
As bond yields compression has moderated after a lengthy period of gradual decline, the pace of income returns moving down with bond yields also slowed. NOI growth, which contributed anywhere from 50 to 250 basis points of return from 2004 to 2014, has continued to 2019, albeit at a slightly slower pace in 2015 and 2017 (Figure 3). Regardless, NOI growth has been positive for eight straight years and this is expected to continue near term as Canada's market fundamentals are largely favourable.

Why Invest in Canadian Real Estate?

From a global perspective, Canada is a highly attractive market for real estate investing. The major reasons to consider investing in Canadian real estate include:

- Low volatility / risk
- High level of real estate transparency
- Low correlations with other asset classes and real estate markets

Figure 4: Volatility of Real Estate Returns*, 2002 1Q2019



** Volatility measured as the standard deviation of rolling 3-year standing investments total unlevered returns from Q4 2002 to Q1 2019*

MSCI Quarterly and Monthly Property Indices for Canada, U.K., Australia and Japan, and National Council of Real Estate Investment Fiduciaries Property Index for the U.S. Volatility measured as the standard deviation of rolling 3-year standing investments total unlevered returns from Q4 2002 to Q1 2019.

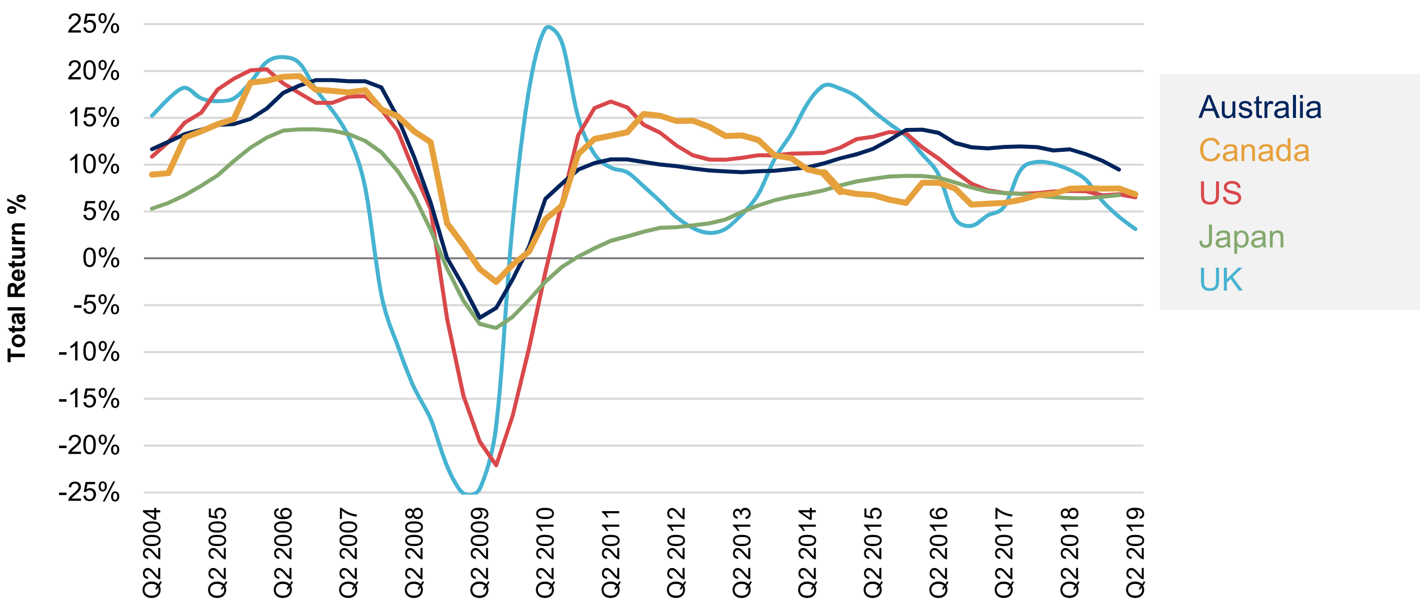
Canada is one of the world's lowest risk real estate markets, supported by political and economic stability, high transparency and a deep and disciplined institutional ownership base controlling a sizeable portion of Canada's institutional real estate. Compared to global peers including the U.K., U.S., Australia and Japan, Canada's real estate market has the lowest volatility / standard deviation over the last 16 years (Figure 4). Investors value the stable economic and political backdrop in Canada, which becomes increasingly important when compared to the escalating geopolitical uncertainty in other regions of the world, such as fallout from Brexit in the U.K., or the rise of fringe and isolationist political parties in other countries.

Canada is the world's fifth most transparent real estate market, closely behind only Australia, U.K., U.S. and France, according to JLL's 2018 Global Real Estate Transparency Index.[4] Canada's high transparency is due to several factors, including well-established legal and regulatory frameworks as they relate to real estate investing, good tracking and availability of real estate market data and robust transaction data which gives investors a clear view of pricing and market conditions. Recent improvements in MSCI data, including the addition of an open-end fund index have also enhanced Canada's overall transparency.

Canada's commercial real estate market is estimated to be $USD 1.32 trillion in total value, ranked 8th in the world, and 9th globally in institutional invested real estate as measured by LaSalle Investment Management's *The Real Estate Investment Universe in 2019* report.[5] Institutional real estate in Canada is much more stable than in most other countries. A sizeable portion of the 'trophy' properties in Canada are held by large, stable pension funds with highly disciplined, long term investment strategies, resulting in low turnover and stable valuations. In addition, Canada's banks have been ranked the world's soundest for eight consecutive years by Global Finance Magazine[6], consistently maintaining strong liquidity, even through the Global Financial Crisis. Access to bank debt throughout past downturns has dampened the volatility of real estate values. Finally, Canada's developers and lenders limit new supply levels relative to other countries, with minimal speculative new supply.

As a result, during the 2008-09 recession the lowest annual total return for the MSCI / REALPAC Canada Quarterly Property Index was -1% (full year 2009), compared to -17% for the U.S. NPI and -22% for the U.K. MSCI Monthly Property Index (Figure 5). Canada's total real estate returns have exceeded 7% in 11 of the past 15 years (2004 to 2018) and exceeded 10% in eight of the last 15 years.

Figure 5: Total Real Estate Returns by Country, 2004-2019

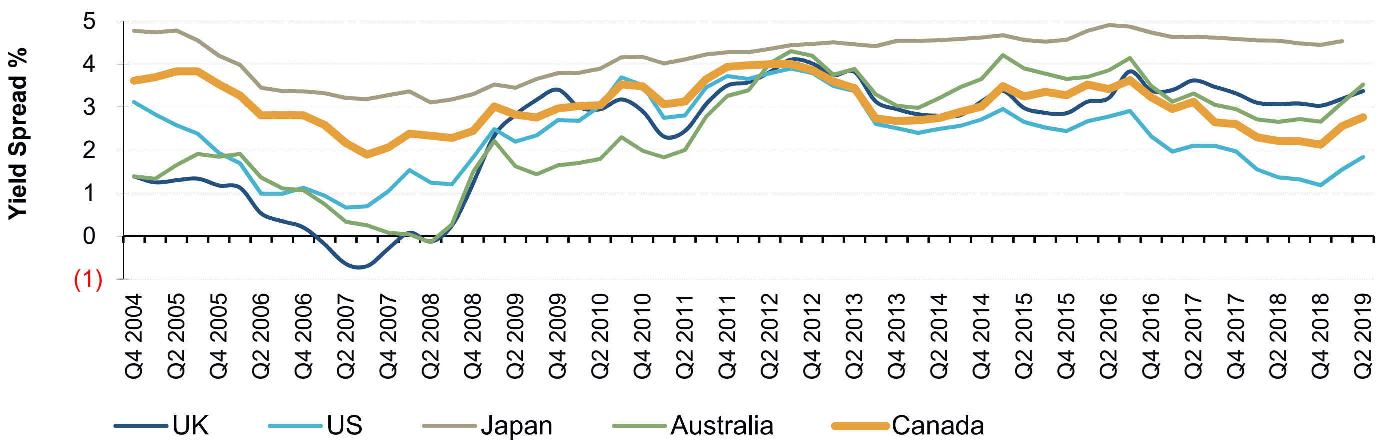


Sources: MSCI Quarterly and Monthly Property Indices for Canada, U.K., Australia and Japan, and National Council of Real Estate Investment Fiduciaries Property Index for the U.S. Data from Q4 2003 to Q2 2019 (Q1 2019 for Australia and Japan). The five countries in the chart were selected based on their good comparability to Canada given their size, structure, economic composition and comparability to Canada, as well as timely availability of comparable return data. Unlevered total returns for the five countries are shown for illustrative purposes only. No assurances are given that these trends will continue. Past performance is not indicative of future results.

An important driver of lower volatility in Canada is the deep institutional ownership base in its commercial real estate sector. Recent estimates suggest Canada's pension funds control just over 50% of the domestic institutional real estate market, but this proportion has been shrinking in recent years.[7] A large component of this ownership is directly managed by vertically integrated real estate teams who utilize low leverage. This type of ownership has brought a high degree of stability to the sector. The supply of real estate in Canada has generally been responsible and measured, closely matching demand[8]; while as landlords, pension plans tend to hold asking rental rates stable, underpinning steadiness in valuations. This is in sharp contrast to some other countries where less disciplined and more highly leveraged ownership groups tend to overbuild, consequently leading to sharp rental rate declines during downturns.

Canadian real estate continues to offer a healthy spread to 10-year government bond yields (Figure 6) which is in line with comparable countries. This spread has been relatively consistent over time and has also exceeded sovereign bond spreads in peer countries. Only Japan, with near zero bond yields for the last several years, has had a higher average real estate income spread than Canada. Canada's 2Q19 spread of 2.8% is below its 10-year average of 3.1%.

Figure 6: Real Estate Income Returns vs. Sovereign Bond Yields



Sources: MSCI Quarterly and Monthly Property Indices for Canada, U.K., Australia and Japan, and National Council of Real Estate Investment Fiduciaries Property Index for the U.S. Data from Q4 2002 to Q2 2019 (Q1 2019 for Japan). Bond yield data from Oxford Economics

Figure 7: 20 Year Quarterly Correlations at Q1 2019

	Global Stocks	Global Government Bonds	Global Corporate Bonds	Global Real Estate Securities	UK Direct Property (IPD)	US Direct Property (NCREIF)	Canada Direct Property
Global Stocks	1.00	(0.50)	0.07	0.63	0.40	0.19	**0.16**
Global Government Bonds		1.00	0.58	(0.08)	(0.24)	(0.12)	**(0.14)**
Global Corporate Bonds			1.00	0.38	(0.04)	(0.24)	**(0.20)**
Global Real Estate Securities				1.00	0.50	0.25	**0.16**
UK Direct Property					1.00	0.57	**0.24**
US Direct Property						1.00	**0.63**
Canada Direct Property							**1.00**

Source: MSCI / REALPAC Canada Quarterly Property Index, S&P/TSX Gross Total Return Index, Bloomberg Canada Sovereign Investment Grade Corporate Composite Bond Index, MSCI All Country Gross World Total Return Index in local currency, Citigroup World Government Bond Index all maturities total returns in local currency, MSCI (U.K.), U.S. NCREIF Property Index total returns in US dollars.

Canada has low return correlations to other real estate markets and other asset classes (Figure 7). Direct, unlevered real estate in Canada has a low correlation with global stocks, global government bonds and global corporate bonds. Among foreign real estate markets, Canada's most positive correlation is with the U.S., which is not surprising given the close economic ties between the countries. Furthermore, within Canada real estate has virtually no correlation to domestic stocks and a slightly negative correlation to domestic bonds.[9]

Generating Real Estate Returns in the Current Environment

Real estate returns typically come from two main sources: property net operating income (NOI) and capital appreciation. NOI is driven by the supply and demand for space (reflected in net rents) and the costs associated with managing a property. Over the medium and longer terms overall NOI in Canada has grown above the rate of inflation[10]; however, there has been differing performance by market and property type, based on supply and demand fundamentals. Capital appreciation is driven by income growth during the hold period and movements in cap rates/yields.

Figure 8: Summary of Real Estate Returns Drivers

Asset Class Drivers	• Risk free rates • Real Estate income spread • Inflationary rental growth
Sector / Market / Asset Selection	• Top Down Selection: Selection of geography / sector • Bottom Up Selection: Selection of assets within geography / sector
Operating Capabilities of Landlords	• Ability to improve net operating income • Managing expenses for buildings

Source: LaSalle Investment Management

Though investments in Canadian private real estate have produced attractive, annualized unlevered returns of 10.0% over the last 15 years and 9.9% over the last 20 years, expectations are that growth, inflation and interest rates will remain 'lower for longer.' Cap rates in Canada are at historic lows and are unlikely to move significantly lower. To generate outperformance, an increased focus on leasing and/or repositioning to drive value are paramount. Furthermore, with both fundamentals and economic growth diverging among Canada's major markets, the dispersion / variation of returns is likely to increase in the short-to-medium term. Thus, proper selection of both geography (market) and sector (property type), with a plan to enhance the income of the asset during the hold period, can substantially improve returns.

Asset selection is also of paramount importance. Since no two real estate assets are the same, the physical qualities of a building, its location, the environmental efficiency of the building and its competition are important drivers of asset performance.

Value-Add Considerations

The backdrop of a growing Canadian economy and rising immigration levels, combined with technology and eCommerce-driven job growth provides a good environment in which to deliver value-added investment performance. With the six major Canadian markets currently in different phases of the market, economic and property fundamentals cycles, different strategies can be successfully employed to drive value-add investment returns. Within the major markets, the four major property types – office, industrial, retail and apartments – are each being impacted by different trends and market forces, and thus each have different value levers which can be utilized to generate attractive, value-add returns.

Figure 9: Canada Value-Add Strategic Themes

Cycle Driven	Asset Optimization	Exploit Advantages
DISCOUNTED - Retail - Alberta - Quebec	**ADD NOI** - Vacancy - Expansion - Entitlement	**MARKET CREDIBILITY** - Preferred Buyer
PREMIUM - Rental Residential - Industrial	**DE-RISK** - Extend Lease Terms - Improve Credits - Diversify	**BEST-IN-CLASS SERVICE PROVIDERS** - Leasing - Management - Development
OWNERSHIP CIRCUMSTANCES - Fund Horizon - Joint Ventures - Recapitalizations	**INSTITUTIONALIZE** - Professional Management & Operations	**OPERATIONAL KNOW-HOW** - LaSalle Canada Team

Source: LaSalle Investment Management

In the current investment environment, value gains typically require a hands-on, active asset management approach, utilizing lease-up, renovation, repositioning and development, or some combination of those – of which there are sufficient opportunities in the current market.

Repositioning, lease-up and develop to core strategies have been shown to deliver attractive returns in Canada, in different markets at various time periods. There are cyclicalities in markets and by sector that creates opportunities to acquire, improve and sell assets, aided by significant churn given record transaction volumes in Canada.[11]

Among the four major property types, there are considerations for each, as well as value-add return generation strategies:

- Industrial portfolios are in strong demand and fully priced. Aggregating and optimizing individual industrial assets (in one market or several) into institutionally managed portfolios and selling those into strengthening markets at a premium, is a good strategy for sectors that may be at a premium or overbought. With industrial's strong return performance over the last several years, an underweight in industrial by many investors and strong investor demand for product, continued strong pricing is likely for stabilized assets;
- Given high demand and high pricing for industrial, development can be an attractive way to higher generate returns.
- Apartments are also in high demand given their highly favourable fundamentals, but cap rates are often too low for a value-add strategy. Like industrial, development of purpose-built apartments can be a good value-add strategy, as is entitling residential density on retail or mixed-use assets, which can then be sold at a premium given in-place zoning to investors seeking to develop;
- Institutional demand for most retail assets is currently low, given rapid changes being brought about by e-commerce and store rationalizations. In urban locations, however, there are numerous retail assets with good value-creation potential – primarily in necessity-based community centres in growing market

areas, and in large regional centre sites which can be entitled for mixed use – that many investors might otherwise ignore. Under-served segments such as urban retail and experiential (i.e., entertainment-oriented) retail create both repositioning and development opportunities.

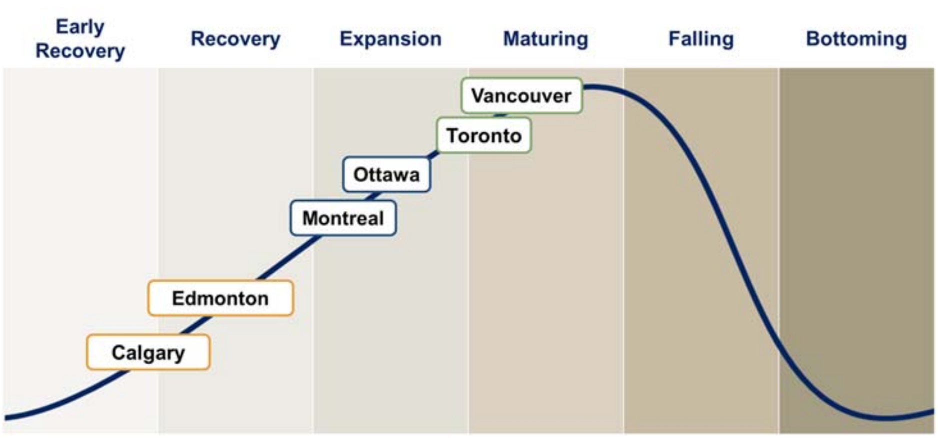
- Locations seeing improving demographics and growing residential and office populations are sometimes under-retailed. Retailers who seek a balance of e-commerce and physical showroom space will seek to expand in such locations, creating opportunities to reposition investments in these locations.

- The nature of office demand continues to evolve as more tenants seek transit-oriented, amenity-rich locations and spaces with open layouts or other unique qualities. Though many investors are aware of this trend, well-located, non-trophy offices can often still be acquired at significant discounts to replacement cost. Capital improvement programs can be implemented to make offices more attractive to modern tenants, e.g., renovating office assets to attract the growing tech sector in both CBD and suburban submarkets is a viable strategy in most (late and mid-cycle) markets.

Late cycle markets like Toronto and Vancouver have seen several years of continuously improving fundamentals, declining cap rates and rising prices, with further improvement in certain sectors still possible. Such markets, however, can still offer significant value add creation opportunities, including:

- Acquiring distressed, under-managed or mis-positioned assets and leasing or repositioning (or both);
- Acquiring good assets at or near the end of their ownership horizon in a closed-end fund or joint venture partnership, or from capital-constrained owners, that may still offer further upside in late cycle markets;
- Industrial development can generate value-add returns, with a development yield plus strong pricing potential at sale, given the significant amount of capital seeking industrial assets;

Figure 10: Canada's Major Cities in Different Market Cycle Phase



Source: LaSalle Investment Management's opinion of capital market, economic and real estate market fundamentals combined cycle positions based on data from CBRE Canada, Conference Board of Canada.

- As vacancy declines and rents rise in tight CBD markets, capitalizing on potentially mis-priced suburban offices that are most likely to benefit from spillover leasing demand, particularly from tech tenants who are unable to secure CBD locations.

- Montreal and Ottawa are at the mid-point of the cycle, with economic growth strengthening and demand momentum improving following a period of relatively flat performance.
- An environment of improving fundamentals allows value-add investors to better capitalize on lease-up and renovation strategies to grow NOI;
- Building and selling newly-built apartments assets in retail or mixed-use properties can be executed in both mid-cycle and late-cycle markets;
- Montreal has long had a cap rate premium compared to other Canadian markets, due in part to lingering effects of an historical political threat to separate from Canada, and the lower economic growth that accompanied that threat. The separation threat has long since passed, and economic growth has been stronger in recent years, driven in part by strong tech job growth and immigration. Montreal's unemployment rate of 5.4% at April 2019 is at an historic low.[12] While cap rates have been moving down in Montreal, there is still room for compression and both lease-up strategies which capitalize on strong leasing demand and selling improved assets to core buyers at a lower cap rate is possible.

In early cycle markets of Calgary and Edmonton, there is greater likelihood for discounted pricing compared to markets with stronger fundamentals. While some investors remain wary of Calgary and Edmonton, they are forecast to be among the top four major cities in Canada in forecast economic growth over the 2019-2023 period.[13]

- With higher vacancy rates in these markets, a lease-up strategy could work but would need to be cognizant that the real estate recovery in these markets could be gradual;
- There is low institutional demand at the current cycle for most retail assets. This suggests opportunities are available to find assets with good value-creation potential, that most investors would otherwise avoid. Under-served segments such as urban retail and experiential (i.e., entertainment-oriented) retail create both repositioning and development opportunities.

As discussed above, Canada currently offers numerous pathways to value add investing, based on geography, property type and capital market conditions.

Conclusions

- Canadian real estate has a long track record of strong returns, low volatility and low correlation with other domestic and international asset classes, as well as real estate in other countries.
- As of 1Q 2019, Canadian real estate is fairly priced given an adequate spread to bonds. If interest rates move up, real estate yields are likely to remain stable given this wide spread.
- Canada's major markets occupy three unique cycle positions, offering different and attractive value-add opportunities to generate strong returns, as well as different dynamics among the major property types that create opportunities to acquire, improve and sell assets for strong returns.
- Canada has a very liquid real estate market, offering numerous opportunities to acquire assets with values that can be increased through proactive management.

[1] MSCI / REALPAC Canada Quarterly Property Index at Q2 2019. All property (including transactions and developments) annual and annualized returns. The Index represents CAD $160.3 billion of institutionally-owned direct real estate in Canada.

[2] National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index (NPI) is a quarterly index tracking the performance of core institutional property markets in the United States. The NPI has a market value of USD $653 billion at Q2 2019.

[3] Bank of Canada Consumer Price Index measured against annual unlevered total real estate returns from the MSCI / REALPAC Canada Quarterly Property Index (2000-2019), Russell Canadian Property Index (1985-1999) and Morguard Property Index (1978-1984).

[4] Jones Lang LaSalle: *Global Real Estate Transparency Index 2018*. www.jll.com/greti/rankings

[5] LaSalle Investment Management: *The Real Estate Investment Universe in 2019.* July 2019.

[6] Global Finance Magazine: www.gfmag.com/magazine/november-2018/safest-commercial-banks-top-50-2018

[7] LaSalle Investment Management estimates based on Statistics Canada and MSCI data.

[8] LaSalle Investment Management calculations of unweighted average annual new supply among the office, industrial, retail and multifamily apartment sectors has equalled 1.1% of existing stock for the past 20 years, based on data from CBRE Canada and CMHC.

[9] LaSalle Investment Management analysis of Canadian direct real estate's correlation to domestic stocks is 0.01 and -0.12 to long term bonds, measured on a quarterly total return basis from Q4 1976 to Q2 2019.Data from MSCI, S&P/TSX and Bank of Canada.

[10] Based on MSCI / REALPAC Canada Quarterly Property Index data, all property NOI for all assets in the Index has grown at annualized rates of between 2.1% and 2.7% over the last three to 15 years, while CPI inflation has averaged between 1.3% and 1.5% over the same period.

[11] CBRE Canada Capital Markets. Full year 2018 transaction volumes were CAD $49 billion for office, industrial, retail, apartments, ICI land and hotels, exceeding the 2017 record of $43 billion.

[12] Statistics Canada, Labour Force Survey at April 2019. Montreal's average monthly unemployment rate of 5.4% for the February-April 2019 period is an all time low based on data back to 1991.

[13] Conference Board of Canada, Metropolitan Outlook I, Winter 2019

Sources: Statistics Canada, Bank of Canada, OECD, MSCI / REALPAC Canada Quarterly Property Index, S&P/TSX, Bloomberg

The information above in relation to expectations has been obtained from or is based upon sources believed to be reliable, but LaSalle does not assume any responsibility for, or make any representation or warranty, express or implied as to the adequacy, accuracy or completeness of, any such information.