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THE REAL DEAL

With Canada's property market in flux, investors are looking at multi-unit residential and industrial buildings as key opportunities in 2017

By *Jann Lee*

Last year was another significant one for the real estate market as British Columbia introduced its tax on foreign buyers and the federal government made another set of changes to mortgage rules. The market remained relatively strong despite the changes, but with the landscape for real estate in flux, many institutional investors are fine-tuning their approach to the sector in 2017.

When it comes to returns, the biggest component will likely come from the income side in 2017, says Kevin Leon, president and founder of Crestpoint Real Estate Investments Ltd., a Toronto-based commercial real estate investment manager. "When forecasting projected returns for Canadian investment real estate in 2017, the majority of the return will be comprised of income, with a smaller component originating from capital appreciation," he says. "With bond yields forecasted to increase, capitalization rates will likely be flat for most property sectors in 2017."

And when it comes to particular types of real estate, multi-unit residential properties are showing continued promise. Investors are keen on the area for several reasons, according to Leon. For one,

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VACANCY RATES IN CANADA

Apartments
3.4%

Industrial
5.5%

Office
12.9%

Retail
7.8%

RENTAL RATES

Apartments (monthly)
$944

Industrial (net asking price per square foot)
$6.46

Office (Class A; net asking price per square foot)
$20.52

Retail (net asking price per square foot)
$26.23

Sources: CBRE Ltd., Canada Mortgage and Housing Corp., REALpac/IPD index

immigrants are helping to bolster the demand for housing in cities, he says.

In addition, millennials who are delaying getting married and having families are helping to drive up the need for apartment buildings, says Marc Cardillo, managing director of hard assets research at Cambridge Associates. "You're also seeing baby boomers who are either tired of owning homes who want to move to urban locations and are looking to sell and monetize their home."

And with Americans facing more difficulties in buying homes since the U.S. financial crisis, Cardillo suggests apartments will continue to do well in that country because of the continual demand from tenants. Leon believes the same is true in Canada, especially after the Canada Mortgage and Housing Corp. imposed stricter mortgage rules last year.

And while Leon says yields from multi-unit residential properties are typically in the range of three to five per cent, he notes many investors are optimistic they can increase their take. "We're in an environment today where people believe that in the long term, they can grow that income by inflation."

Indeed, Cardillo notes investors in multi-unit residential properties have the advantage of securing shorter leases than would typically be the case with other types of real estate. "With offices where the average lease terms are maybe seven or 10 years, it takes longer for those inflationary trends to be passed through in the form of higher rents," he says.

Ivanhoé Cambridge, the real estate subsidiary of Caisse de dépôt et placement du Québec, is among the investors taking an interest in multi-unit residential properties. "Multi-residential is an asset class we like a lot, actually," says Mario Morroni, executive vice-president of strategy and capital allocation.

In its case, the majority of its properties are in the United States. "Given that there may be a slight recession possibly over the next four years in the U.S., we like multi-residential since it's counter cyclical and more resilient in that kind of condition," says Morroni. "Your rent will roll over on a yearly basis, so if inflation is there, you can capture some of that more quickly than in some of the other sectors like office and retail."

But Canadian cities still hold plenty of opportunities for institutional investors, according to Leon. "If you look at Toronto, most buildings being constructed are condos. Once they're built, they're sold to users, and developers have no ownership of the assets after," he says, noting a key trend at the moment is towards rental buildings.

"What's happening now in some cities is that institutional investors are building new apartments to rent out, so they're not selling them as condos and can retain the income for long-term appreciation."

There's an opportunity to tap into a market of renters who want modern accommodations, according to Robert Douglas, managing director of real estate investments at OPSEU Pension Trust. He notes that in cities such as Toronto, many apartment buildings are old and lack popular amenities such as ensuite laundry.

The allure of last-mile distribution

In addition to the favourable outlook for multi-unit residential properties, industrial areas — specifically logistical buildings — that provide last-mile distribution of goods to their final destination are popular among investors due to the boom in e-commerce and expedited online shipping, according to Cardillo.

"Historically, you can put a big warehouse in a suburban location, and it wasn't as important that it had to be near major population centres because you had more time to get those goods to the stores," he says, adding that the popularity of online retailers has meant there's more demand for warehouses that are closer to the market.

Morroni notes Ivanhoé Cambridge began looking at logistical buildings a few years ago given the need for strong supply-chain infrastructure around the world.

"We've noticed that not only do logistics give you an interesting current return, but because of the interest that the asset class or sector has attracted, a lot of the capital is going in there and that's pushed cap rates and therefore capital values up," says Morroni.

The growth of middle-class consumers in cities around the world is also fuelling interest in logistical buildings, he adds. "Just being able to satisfy the consumption driven by the growth of this new cohort is going to create a demand for supply-chain logistics."

However, it can be challenging to find locations to build warehouses because they usually require large heights and a significant amount of space, says Leon. As a result, investors often find it easier to buy vacant spaces on the outskirts of major cities. As an alternative, Leon says investors that want locations closer to urban centres can buy older industrial buildings and retrofit them into a warehouse.

That's what OPTrust plans to do with an abandoned manufacturing plant it acquired in Brampton, Ont., according to Douglas. He says the plan is to demolish the building and convert it into a large warehouse by the end of the year.

"It will have lots of clear height to store goods and multiple shipping doors," says Douglas.

Ivanhoé Cambridge, on the other hand, initially explored investing in logistical properties in the United States but it ultimately found the opportunities too expensive, according to Morroni.

"We looked probably for the last 2-1/2 years . . . and we just had a hard time with the pricing because what we like to do is not just buy the asset, we like to buy the business that goes with it," says Morroni. "That's where we think we can also create value."

As a result, the company looked beyond North America and partnered with global developers in Australia, China and Singapore, he says. It's also thinking about investing in Brazil, India and Mexico, although Morroni says any plans in those countries are in the early stages.

Retail opportunities become riskier

While logistical buildings have benefited from e-commerce, the trend has negatively affected many retail properties, says Cardillo. "Retailers are moving in and out. . . . There's always a lot of bankruptcy risk with certain retail tenants. That's a sector that's maybe becoming riskier over time, whereas historically, it's been a low-risk property type."

While Leon agrees online shopping has had a negative impact on big-box retailers, he thinks major shopping centres and urban stores will continue to do well. "Retail will always have a place in society because it's an event. People are still going to want to try on clothes and go out for entertainment," he says.

Major regional shopping centres offer a convenience to those who drive and live in the suburbs by offering a variety of vendors in one place, according to Leon. Urban retail, he adds, is accessible to those who live in the city and hardly drive, while shopping centres anchored by food and drug stores are still essential because they're convenient for those living in surrounding neighbourhoods.

Some institutional investors continue to see value in the retail sector. Calvin Jordan, chief executive officer of the Nova Scotia Health Employees' Pension Plan, says it continues to be the biggest component of the fund's real estate portfolio, taking up about 50 per cent of its allocations.

In fact, the pension plan, which invests in a comingled fund with other institutional investors, is redeveloping several outdated shopping malls in Canada, Jordan notes.

As for investors like Ivanhoé Cambridge that have a large retail portfolio, Morroni says changes in the sector have compelled it to be more strategic.

"Over the past four or five years, we've been . . . culling our portfolio, making sure that the best assets in the market are remaining dominant. We've also decided to have the off-price outlet or mills concept, which for us adds to the resilience of our portfolio," he says.

In Alberta, for example, outlet malls have done well in comparison to other types of retail properties, says Morroni. Like Leon, he thinks retail properties won't necessarily suffer from the phenomenon of online shopping.

"Amazon is now looking at physical space, because they're realizing that a strictly e-commerce experience is not what the consumer wants," says Morroni.

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WHAT ABOUT OFFICES?

Millennials, freelancers and entrepreneurs are changing the types of office properties in demand, says Crestpoint's Kevin Leon. While financial institutions continue to be the dominant tenants in cities, he says there are opportunities to look beyond downtown areas in light of the growth of technology workers.

"What that means for institutional capital is they can be a little more creative on what kind of offices they're looking at, especially if it's near the downtown core or transit," says Leon.

Co-working spaces are another area of growth, according to Ivanhoé Cambridge's Mario Morroni. In fact, Ivanhoé Cambridge rented out part of an office tower in Montreal to a large co-working provider last year, he notes.

Many tenants are looking for offices that allow for flexibility, he adds.

"They want to be able to grow their size, so they take up more space than they need, sublet that and when they grow their business, they take it back."

RATES OF RETURN

Canadian real estate returns as of September 2016:

Retail
8.5%

Office
6%

Industrial
6.7%

Residential
8.5%

Source: REALpac/IPD Canada quarterly property index