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Investment and Economic Outlook

While the quarter is a welcome relief from a challenging 2018, the flip side of the coin for investors is that valuations are no longer a tailwind and, consequently, long-term expected returns across asset classes should be more muted going forward.

Debate around a looming recession has also intensified. Global economic data has slowed significantly, inflation rates remain low, interest rates are falling, and global central banks are signaling that rate hikes will be off the table for the foreseeable future. Inverted bond yield curves (where longer-term bonds yield less than short-term bonds) are also being looked at as an ominous sign, given their presence prior to historical recessions. In our view, the odds of a global recession may have increased; however, we do not believe it is on the horizon for the next 12-18 months and the cycle may be prolonged amid lower interest rates. The extended cycle view is anchored in our fundamental macro-economic outlook.

Fundamentally, the global economy is clearly exhibiting late cycle dynamics. Growth is expected to be slower but central bank activity, positive trade developments, and a strong U.S. consumer are likely to keep global economic activity from stalling. Sentiment is starting to reflect the slowdown and we believe there is a greater probability that economic growth in 2019 will surprise to the upside versus the downside. We continue to remind ourselves that late-cycle returns can be very strong and there is a risk in becoming overly defensive too early.

Prudent deployment of capital in real assets is increasingly important as allocations increase among investors. Our counsel to the market has been to continue with strategic allocations into real assets due to the potential diversification benefits in the next downturn. In the private debt and mortgage segment, we continue to see attractive lending opportunities in early stages of the real estate development life cycle. In commercial real estate, we view redevelopment of existing assets as an accretive avenue to place capital. Finally, in global infrastructure, we continue to believe that the mid-market segment benefits from the absence of larger global pension players. An ability to access these pockets of low capital availability will help investors reach their target allocations while also achieving suitable expected returns.
Canadian Commercial Mortgage Market

CMLS Financial estimates that total outstanding commercial mortgages held by banks, insurance companies, CMBS securities, public and private investors, etc. to be $294 billion.

Figure 1: Outstanding Mortgage Balance

![Figure 1: Outstanding Mortgage Balance](source: CMLS Financial, 2018)

Commercial mortgage origination activity reached $55 billion in 2018 (see Figure 2). This is a 9.8% increase from the previous year. We anticipate commercial mortgage lending to be strong for strategically located real estate assets in major markets throughout 2019.

Figure 2: Mortgage Origination Activity

![Figure 2: Mortgage Origination Activity](source: CMLS Financial, 2018)

The five and 10-year Government of Canada ("GoC") bond yields are at 1.52% and 1.62% at the end of the first quarter of 2019 (see Figure 3). This equates to a quarterly compression of 36 and 34 basis points ("bps"), respectively.

Figure 3: GoC and Mortgage Spreads

![Figure 3: GoC and Mortgage Spreads](source: Bank of Canada. As at Mar 31, 2019)

Commercial mortgage spreads for high-quality real estate have increased to 165 – 185 bps for five-year term mortgages and 175 – 195 bps for 10-year term mortgages. After a brief decline over the first three months, all in rates (GoC + Spread) ended the quarter in line with 2018 year-end levels (see Figure 4).

Figure 4: Commercial Mortgage Spreads

![Figure 4: Commercial Mortgage Spreads](source: CMLS Financial. As at March 2019)

Commercial mortgages that are focused on high-quality real estate and experienced operators can help reduce the risk profile of a potential mortgage investment. These types of mortgage investments may benefit a balanced portfolio by generating stable yield throughout a more volatile macro-economic environment.
Canadian Commercial Real Estate Market

Office

The demand for office space across the country was positive over the first quarter with vacancy rates decreasing by 40 bps to 11.5%. Most of this low vacancy continues to be driven by robust office markets like Vancouver and Toronto, while Edmonton and Calgary continue to face headwinds (see Figure 5)

![Figure 5: Office Vacancy by City](source: CBRE Limited. As at Mar 31, 2019.)

In Alberta, “flight to quality” into core downtown space with attractive amenities continues to be top-of-mind for suburban tenants given comparable gross rental rates. To be competitive, landlords see the incentive to reposition older class buildings (Class B and C) to attract quality tenants and fill vacancies.

Another trend across the office market is the growing demand from co-working operators (e.g. Regus and WeWork). Co-working space offers users lease flexibility and an innovative environment to work. For landlords, incorporating co-working space into their office buildings can create additional value for the property and increase their service offering. Currently, Vancouver leads in having the highest co-working space as a percentage of total inventory (see Figure 6) and we anticipate the co-working footprint to increase across Canada.

![Figure 6: Co-working Presence in Canada](source: CBRE Limited. As at Mar 31, 2019.)

Ending Q1-2019, Canada has 16 million square feet of new office development under construction, which is the highest level of activity since Q4-2015. A majority of construction is occurring in Toronto and Vancouver where preleasing demand is largely driven by technology and finance tenants. Although construction levels are elevated, it is only anticipated to relieve demand in the short term.
At the end of 2018, national retail vacancy rates dropped by 60 bps to 6.3%, after reaching a historic high resulting from the demise of Sears in late 2017 (see Figure 7).

Regional shopping centres saw a slight recovery from the high vacancy experienced in early 2018, which indicates some traction in repurposing the vacancies left by Sears. Landlords continue to focus their redevelopment strategies on differentiated retail offerings including food halls, luxury brands, and international retailers. In fact, 2018 welcomed 53 international retailers into Canada, with a majority being food and beverage tenants (see Figure 8).

Landlords still need to be cognizant of the headwinds the retail industry is facing. Consumer debt levels in Canada remain high, which have tightened discretionary spending. According to Euromonitor, the rapid growth of e-commerce sales is not expected to soften, but rather double to 16% of total retail sales by 2023. Additionally, brick-and-mortar retailers are feeling the pressure as five retail brands have announced closure of their Canadian operations, including fashion retailers like Payless ShoeSource.

By focusing on the right retail formats, including mixed use, destination tenants, on-transit and experiential sites, landlords can better position themselves in a dynamic retail environment. This is reflected in the larger proportion of mixed use sites currently under construction (see Figure 9), as landlords see the value in being close to consumers in strong trade areas.
Industrial

Over the quarter, national industrial vacancy hit an all-time historic low of 3%, and a similar story can be said across many major cities across Canada (see Figure 10).

Figure 10: 10-Year Historical Availability Rate by Market

* Represents the Waterloo Region
Rental rates in Canada have accelerated to reach historic highs with pronounced growth in Toronto and Vancouver (see Figure 11).

![Figure 11: Rental Rate Growth Across Major Cities](image)

(Even with higher rental rates, logistics, distribution and warehousing tenants — who represent 79.4% of user demand according to CBRE Limited — are able to weather these conditions given that rental costs represent less than 5% of their total operating costs (see Figure 12). Conversely, logistics costs such as transportation, inventory and labour account for 80% of total operating costs. Given this larger proportion, these users seek to alleviate logistic related costs by preferring to have efficient industrial space with proximity to major transportation nodes and pools of labour.

![Figure 12: Industrial User Total Operating Costs](image)

Market supply simply has not been able to keep up with demand. New supply in 2019 is not expected to ease tight market conditions, as it represents only a small fraction of existing inventory and 70% have already been pre-leased (see Figure 13).

![Figure 13: Industrial New Supply (Pre-leased vs. Available Space)](image)

* Represents the Waterloo Region

Multi-unit Residential

In the past several years, home ownership in Canada has declined given persistent housing unaffordability issues, which has led to the growing economic attractiveness of renting from a user’s perspective. Since the second half of 2017, the monthly mortgage payment on a median-priced condo has hovered above the average monthly rent of a two-bedroom condo in Canada (see Figure 14). This spread is a conservative measure as it does not consider other homeownership expenses (e.g. property taxes, condominium fees, etc.).

Figure 14: Renting vs. Ownership

Unaffordability is also anticipated to widen given the rising cost of home ownership and the stress test implemented by the federal government, increasing the difficulty of qualifying for a mortgage. These issues are pronounced in major cities like Vancouver, Montreal and Toronto, where purpose-built apartment vacancy rates are below the national average. (see Figure 15).

From a supply perspective, Canada’s purpose-built rental supply has historically lagged condominium supply (see Figure 16). Despite a rise in rental starts in the past several years, developers are still finding condominium developments attractive given the potential for higher rates of returns. Consequently, major markets like Vancouver and Toronto desperately need to fill the void for rental supply to meet the demand for rental units, which has been driven by population and job growth.

We believe the trend of home ownership unaffordability coupled with population and job growth will drive demand for purpose-built rentals in the long term.
Global Infrastructure

According to Inframation News, 2019 deal activity has had a slower start with Q1-2019 totaling US$81 billion compared to US$101 billion in the same quarter last year. Transactions for Q1-2019 were largely in the Transport (20%), Renewables (19%), Power (17%) and Energy (25%) sectors, with increased activity in Transport, Power and Social Infrastructure sectors each gaining 4%, 3% and 4% respectively over the same quarter last year (see Figure 17). Renewable and Energy transactions saw the biggest decrease in activity over the same quarter last year and were both down 7%.

Transactions in operating or brownfield assets were up over 20% quarter over quarter at US$46 billion, with the decrease coming from greenfield investment which was down more than 45% compared to the first quarter of 2018 at US$35 billion (see Figure 18).

Lowering Return Expectations

While a single quarter is not a significant data point, the decrease in greenfield activity is in line with a broader industry trend. A number of infrastructure managers have launched core and super-core funds that target highly contracted or regulated operating assets. In a recent survey, Preqin noted that more than half of investors are seeking single-digit returns with over 30% seeking returns of 7% or less.
This trend has emerged as significant capital has been raised for infrastructure funds, but as noted in our last Real Assets Market Report, approximately 40% of fund raising has been completed by only five managers. This aggregation of capital has created substantial competition for the largest assets in the market.

**Seeking Better Risk Adjusted Returns**

In our opinion, this rise in competition at the largest end of the market will create opportunities for managers to outperform super-core infrastructure. A core-plus manager that is able to develop greenfield opportunities can offer higher risk-adjusted returns. While greenfield developments can be risky ventures with significant uncertainty around permitting and contracting of assets, a manager working with like-minded partners that have expertise in their specific geography and sector can significantly de-risk a development. Building assets for long-term cash flow and having partners with aligned interest in the development of those assets can ensure the successful transition of a greenfield development into a core, long-term asset for the portfolio.

In addition to measured greenfield exposure within a portfolio, the mid-market segment can provide another source of outperformance for the portfolio. The mid-market offers a greater volume of deals, and Preqin reported that 77% of the transactions completed in 2018 had enterprise values of less than US$500 million and 45% were less than US$100 million.

Larger transactions are often sold via broadly marketed auctions with sophisticated counterparties seeking to maximize price. Mid-market assets are more likely to transact on a relationship basis with smaller developers or asset owners. Fund managers focused on transacting with like-minded counterparties may be able to acquire assets at attractive risk-adjusted rates of return vs. larger deals.

Mid-market infrastructure assets can offer similar risk-adjusted returns to larger assets as they often benefit from a similar regulatory, legal and contractual framework, which can lead to stable, long-term cash flow. For example, government counterparties participate in both smaller renewable projects as well as larger assets. This is a distinct advantage compared to mid-market equities, which tend to be smaller companies that may have disadvantaged business models because of a lack of scale, such as limited distribution capabilities.

A manager that is able to transact within the mid-market and develop select greenfield opportunities within a core-plus mandate may be able to offer a premium risk-adjusted return to newly available super-core and core funds from mega-managers.
Conclusion

The mortgage market continues to be active. Lenders who are focused on quality real estate, experienced borrowers and prudent loan fundamentals are likely to generate stable yield throughout a more volatile macro environment.

Within the commercial real estate market, we expect capitalization rates to remain stable given sound property fundamentals across property types.

As capital continues to aggregate to the largest infrastructure managers, we anticipate greater competition for large-cap, core infrastructure. Investors may find outperformance through exposure to mid-market infrastructure, value-add opportunities or greenfield development.
Growth.

It’s what we do.
Broader offerings. More opportunities.

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