INSIGHTS
FOR INSTITUTIONAL INVESTORS

APRIL 2014

The Canadian institutional real estate market: why is it a popular place?

HIGHLIGHTS

Why is the real estate market popular? This paper explores some of the reasons why, including market performance, accessibility, and diversification.

Performance: Canadian real estate performance ranks as one of the best among global property sectors. Positive fundamentals across most property types and geographies have led to this outperformance.

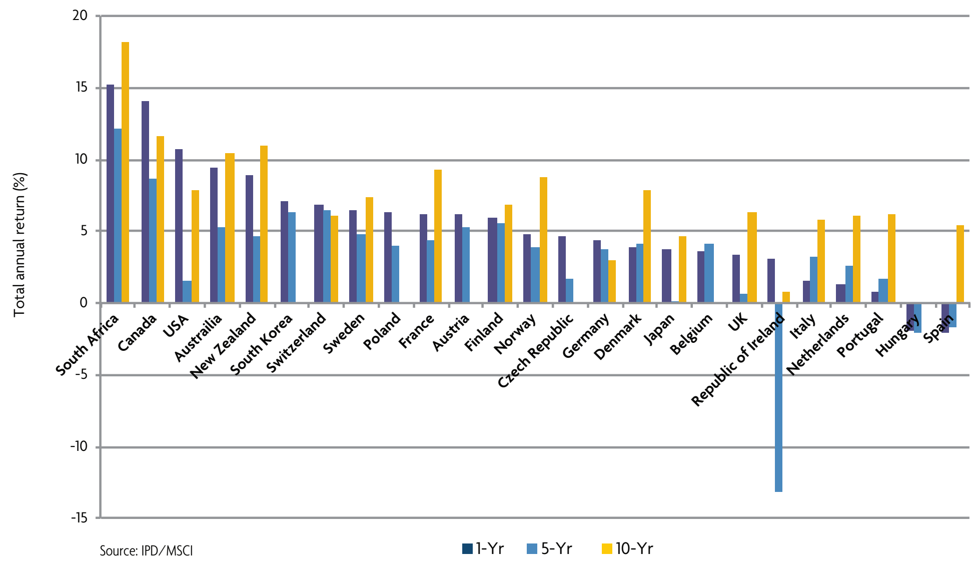
Accessibility: While real estate is less liquid than publicly-traded assets such as stocks and bonds, the increase in institutional investment in this sector has contributed to a greater investable universe and greater transparency.

Diversification: Real estate's low correlation with stocks and bonds has provided diversification benefits in multi-asset class investment portfolios. Property lease structures and healthy fundamentals have made real estate an effective inflation hedge while preserving capital over time.

Sun Life
INVESTMENT MANAGEMENT

Over the past decade, Canadian commercial real estate investment performance has ranked among the best globally when compared to the 25 countries included in the IPD Global Property Index. This trend continued through 2013, as Canada's commercial real estate markets generated a total return of almost 11%.

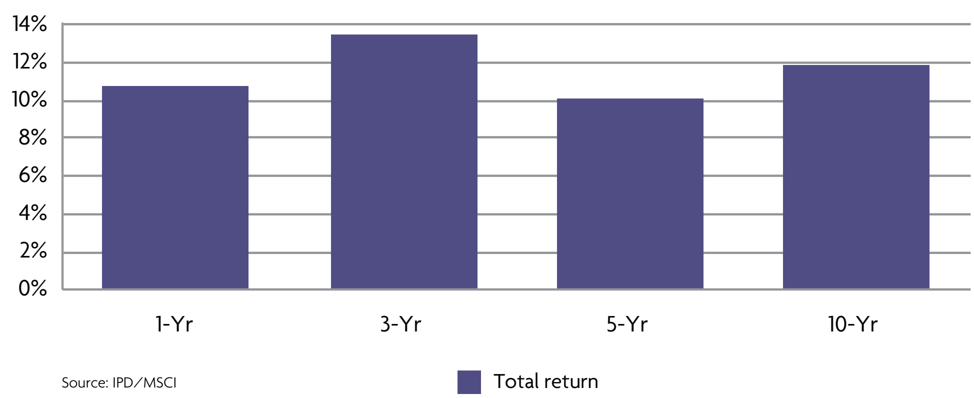
Real estate time-weighted returns through 2012



Source: IPD/MSCI

The real estate sector continues to gain in popularity as an institutional core asset class, representing approximately 10% of pension assets in Canada during 2012 according to the Pension Investment Association of Canada. Based on our research, the investable market capitalization of institutional real estate in Canada has more than tripled in the last 15 years – exceeding an estimated $200 billion at the time of this publication.

Canadian directly-held real estate returns 2013



Source: IPD/MSCI

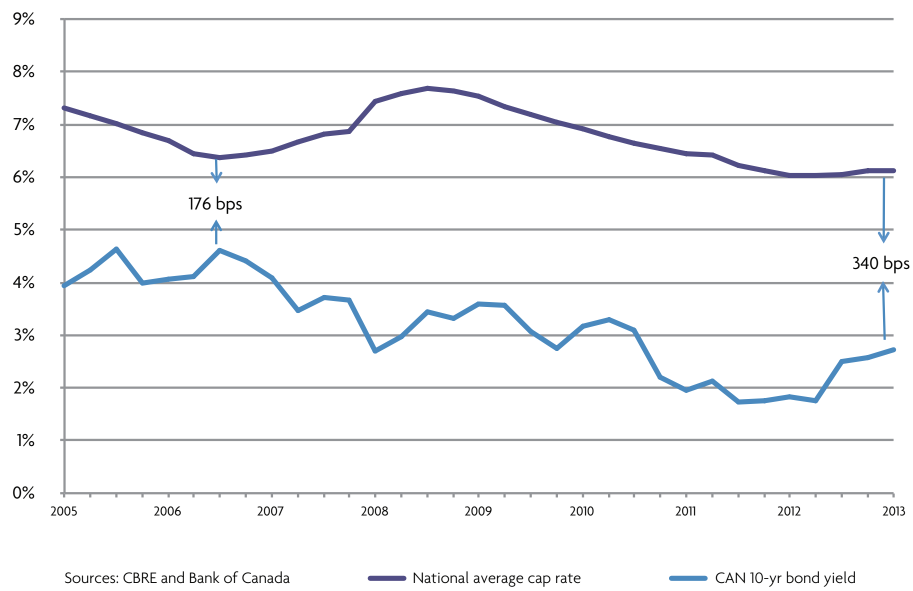
MARKET TRENDS

In the past six months, investor appetites for Canadian commercial real estate have exhibited a flight-to-quality behaviour becoming more selective given current pricing levels and the softening economy. Yield compression continues, but only in select core markets and among prime properties featuring modern functionality with strong credit tenant profiles and lease terms. Other, non-core properties have begun to experience a flattening or even a reversal to higher yield levels. This reflects an expectation of rising interest rates, as well as, an outlook for slowing near-term rent growth due to slightly deteriorating occupancies.

Property transaction activity began to slow in the third quarter of 2013 in response to the steep rise in bond yields and the subsequent pullback by the Canadian real estate investment trust (REIT) sector beginning in June 2013. This void in demand caused a short-term rise in capitalization rates for lower quality, non-core class-B assets. REIT prices have since stabilized at lower levels, while traditional institutional long-term investors such as life insurance companies and pension funds continue to provide liquidity to the market.

Capitalization rates, given their relatively wide spreads over risk free rates, have generally absorbed initial increases in interest rates helping to preserve capital. As interest rates rise further, we would anticipate the potential for additional uplift in capitalization rates. However, these rate increases should correspond with improving economic fundamentals which should translate into future higher operating incomes and capital value growth or stability.

Average capitalization rate versus 10-year Government of Canada rate



Sources: CBRE and Bank of Canada

In the short term, the anticipated delivery of new construction in select markets has led to softer supply and demand fundamentals. Once this new supply has been delivered, the relatively healthy market fundamentals and strong investor demand should support stable capital values into the foreseeable future across most sectors, especially in prime central urban locations and the more robust western provinces.

Our outlook over the next two years consists of income returns of approximately 1.5% per quarter with only slight, if any, contribution from capital growth. However, total returns beyond this time frame should revert back to long-term annual averages of 8% to 10%, with the potential for further capital appreciation through active management.

DIVERSIFICATION BENEFITS

Correlations between Canadian commercial real estate and stock and bond broad market indices have been low to slightly negative over the past 10 years. As a result, the sector has delivered important diversification benefits to investors who have included real estate in a multi-asset class investment portfolio.

Although we expect near-term real estate returns to be more income-oriented with little or no capital growth, this performance and the cyclicality of the sector should continue to provide diversification benefits to multi-asset class portfolios in the long run.

INFLATION HEDGE

Real estate often performs as an effective inflation hedge. There are three reasons for this. (1) Real estate lease structures are designed to pass the burden of increased operating expenses onto standing tenants. (2) Rental rate increases are often achieved during periods of stronger economic conditions or higher inflation pressures, working to preserve capital values over time relative to other fixed income investments. (3) Inflated construction costs often act as barriers to new competitive supply when they negatively impact project profits.

Canada's commodity-based economy has been hurt by slowdowns among its key trade partners, primarily the U.S. and, to a lesser degree, China. With this and other headwinds in place, inflation has been running well below the Bank of Canada's 2% target.

We do not anticipate inflation pressures in the near term. Any inflation pick-up should coincide with a U.S. turnaround.

NEAR-TERM OUTLOOK

Canadian commercial real estate has been one of the top performers in the global property sector over the past decade – exhibiting healthy fundamentals going into and coming out of the recent economic downturn. While we anticipate a slight softening of market conditions and less capital growth due to flattening yields in the near-term, we expect both stable cash flows and capital values into the future.

This outlook bodes well for the continued delivery of solid and consistent investment performance, as well as enhancement to risk-adjusted returns within institutional multi-asset portfolios.

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