

PERSPECTIVE ON CANADA'S COMMERCIAL REAL ESTATE MARKET FOR 2021

BentallGreenOak 

BentallGreenOak (BGO) remains optimistic about the prospects for Canadian commercial real estate over the longer term, says Phil Stone, a principal and its head of Canada Research. He told the *Benefits and Pensions Monitor* 'Perspective on Canada's Commercial Real Estate Market for 2021' webinar that there are a number of economic, capital market, and technological forces that are shaping the real estate landscape. While many of these trends aren't new, they have been accelerated by the pandemic and have risen to the forefront.

The economic recovery is currently uneven and, because of this fragile economic backdrop, interest rates are expected to remain lower for the foreseeable future.

In this capital markets environment, "we're going to continue to see tailwinds for real estate, driven by strong investor interest in the asset class," said Stone. As an example, in a traditional 60/40 stock/bond portfolio, valuations are stretched and there's an asymmetric outlook for investment returns. For this reason, "real asset" or "alternative" investment strategies will continue to gain momentum. And, despite a weaker look on fundamentals, real estate should benefit from investors' search for yield, and strong capital flows, which will help support capital preservation, according to Stone.

Cap Rate Spreads

In the current environment, cap rate spreads over risk free rates are at record wide levels, mostly due to the low interest rate environment. Debt capital is available for high quality assets and the cost of capital is quite attractive. "In fact, lending spreads have come back in to where they

were prior to the pandemic. When you look at a mortgage rate of about 2 - 2½ per cent, it makes for a pretty compelling return profile, even in sectors where pricing has become more fulsome like industrial and multifamily."

The challenges in real estate start with the future of office. Mounting near term headwinds and shifting workplace strategies are really clouding the long-term outlook for office, said Stone. "When thinking about the evolution of the office, it's best characterized as a better integration of "work and home", rather than "work from home", as hybrid work models evolve."

But the physical office still matters, he said. It's critical infrastructure for both culture and collaboration. And the pandemic is likely to amplify a "flight to quality" for occupiers.

According to Christina Iacoucci, Managing Partner, Portfolio Manager for the Sun Life General Account, BentallGreenOak, there had already been a growing trend around wellness in the office space pre-pandemic, and like other things that have accelerated due the pandemic, the wellness requirement went from a nice-to-have to a must-have overnight. "The older buildings are very capital intensive and, in many cases, it's not economically feasible to upgrade those buildings to a level that would meet wellness requirement today," said Iacoucci.

Simon Holmes, managing director and co-head of Canadian investments at BentallGreenOak, can't remember a time where there's been so little certainty on what the future path is on the investment side. "We're used to dealing with risk, dealing with uncertainty, and how to price it. Today, we're dealing with the short-term economic impact of a recession caused by COVID and, on the office side

specifically, dealing with the potential permanent changes. It really means we're taking a cautious, wait-and-see approach to the office sector."

Tenant Relationship

On top of that is a revaluation of how tenants are looking at their relationship with their space. "The tenant interview is an even more important part of the diligence process. It is about really understanding what the tenant is using the space for, how critical it is for their operations, and determining the level of costs that are required to make a building attractive to tenants," said Holmes.

Kristen Ede, managing director and portfolio manager for BGO's prime Canadian property fund, said the pendulum of change within office is still swinging, and we don't know where it will land. According to Ede, BentallGreenOak is focused on four key things to ensure its portfolio is resilient and adaptable, focusing on buildings that are 1) top quality, climate resilient, and sustainable assets with superior health and wellness features; 2) located in prime multimodal and amenity rich locations; 3) have strong and defensive rent roles and lease flexibility; and 4) located in stable and highly liquid markets.

Another area that is important is climate change and climate resiliency, which has been a significant area of focus for BentallGreenOak. "Through our innovation lab, we've been able to identify climate risk factors across all of SunLife's North American real estate assets, followed by the creation of action plans, per asset, which outlined operational risks and actions needed to mitigate these risks. Now, we are in a position to expand this program across other locations and our clients' portfolios."

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