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Through the Noise:
Real Estate in the Post-Pandemic Era

The post-pandemic era produced the most drastic interest rate increase in fifty years and has propelled Canadian capitalization ("cap") rates 20% higher, resulting in downward pressure on real estate valuations.[1] So, it does beg the question: **how has Canadian commercial real estate provided stable returns in the face of such severe valuation headwinds and what do we expect of performance going forward?**

[1] CBRE All Property Type Capitalization Rate.

Performing in the Face of Higher Capitalization Rates

Cap rates are the price of real estate income and are analogous to the Price-to-Earnings ("P/E") ratio for stocks. Unlike the P/E ratio, however, when the cap rate moves higher, the value attributed to the income is reduced:

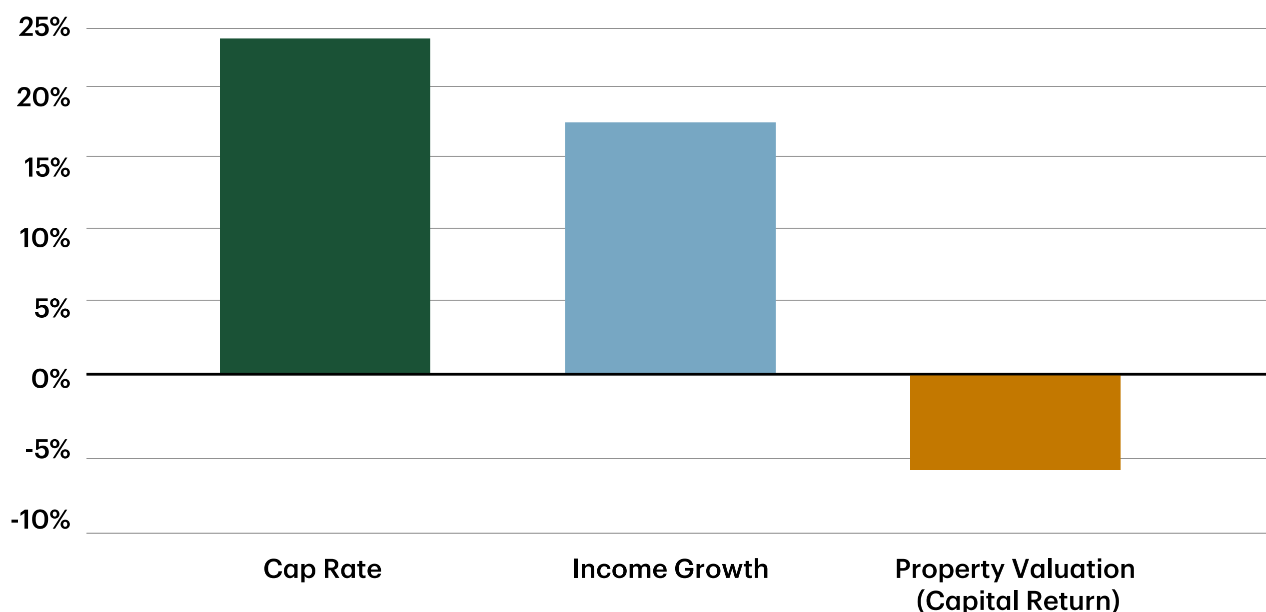
Income / Cap Rate ↑	=	Property Valuation ↓

In 2022 and 2023, we witnessed the "battle of rising cap rates and income," with the winner determining the direction of real estate valuations. As shown in **Figure 1**, the cap rate expansion of +20% outpaced the income growth of 17%, causing overall valuations to fall. Considering the magnitude of the cap rate expansion, the drop in valuations was minimal due to robust income growth.

However, valuations are only one component of real estate returns. The current income streams coming into the portfolio are another factor. In 2022 and 2023, the current income performance outweighed valuation changes, thus providing positive overall performance.

2022 and 2023 illuminates how income ultimately drives performance through valuation stabilization in the face of cap rate increases, and through current income returns. Keeping this in mind, we will assess short- and long-term income drivers (supply and demand) for Canadian real estate, but first we must evaluate the recent cap rate move from a historical and relative context.

Figure 1: Income Growth Stabilizes Valuations Despite Large Cap Rate Increase, Dec 31, 2021 - Dec 31, 2023



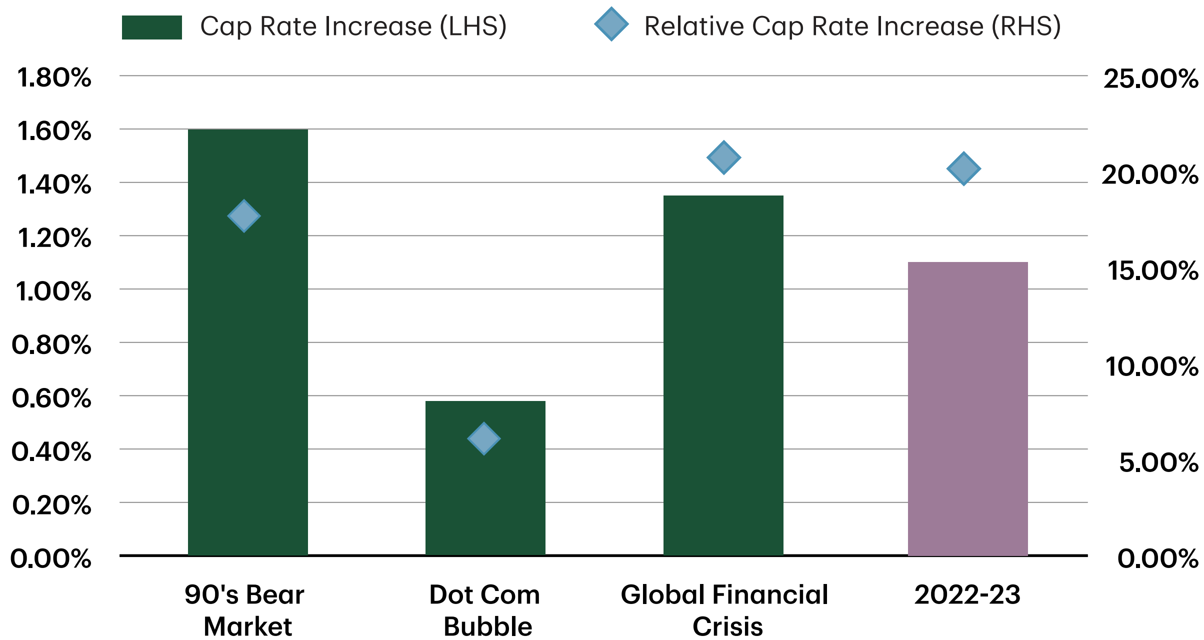
CBRE All Property Type Capitalization Rate.
Source: MSCI Property Index. Dec 31, 2021 – Dec 31, 2023.

Valuing Real Estate in the Reflationary Era

Forecasting cap rates is essentially anticipating the price investors will pay for the income of real estate. The recent drop in the value of income (rise of cap rates) can be compared to previous cap rate expansions and to the price of 'risk-free' income (i.e. Government of Canada ("GoC") bond yields) to evaluate possible cap rate pathways.

Figure 2 compares today's cap rate expansion to historical expansionary periods. The recent relative increase of 110 basis points (6.6% current versus 5.5% trough) has reached historical peaks and indicates most of the current cap rate expansion is likely in the rearview mirror. The previous two cap rate peaks (Dot Com bubble and Global Financial Crisis) were followed by average three-year annualized returns of 8.5%.

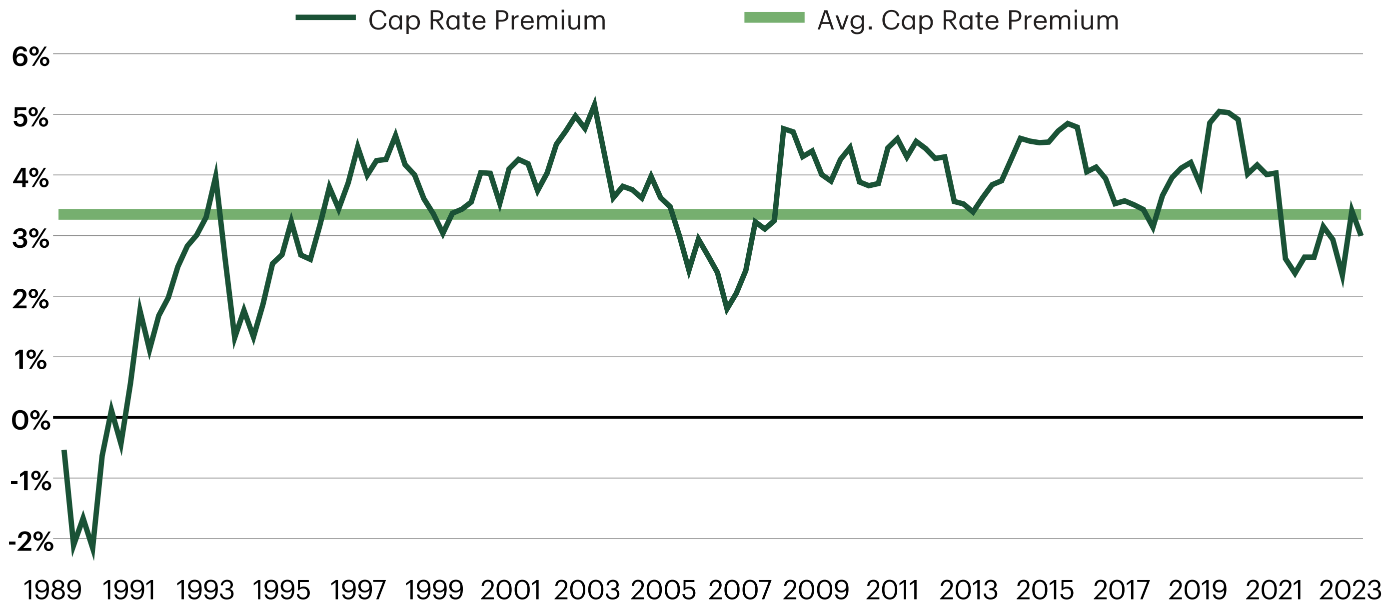
Figure 2: Historical Cap Rate Expansions



Source: CBRE All-Property Type Cap Rate.

We must also compare the value of real estate income, (i.e. the cap rate), to the price of 'risk-free' income, captured by the GoC yield. GoC yields began rising in 2021, which caused the cap rate premium (cap rate less GoC yield) to fall, as shown in **Figure 3**. Subsequently, cap rates rose at a faster pace than GoCs, thus bringing the premium near the historical average. In isolation, this suggests cap rates should remain relatively stable at today's level of interest rates.

Figure 3: Cap Rate less 10-year GoC Yield Near Historical Average



Source: CBRE All-Property Type Cap Rate. Bloombeg Financial.

The severity of the recent cap rate expansion indicates compelling entry points from a valuation perspective. However, as demonstrated by the stable performance amid the fastest rising cap rate cycle on Canadian record in 2022 and 2023, it is the income that will ultimately drive performance.

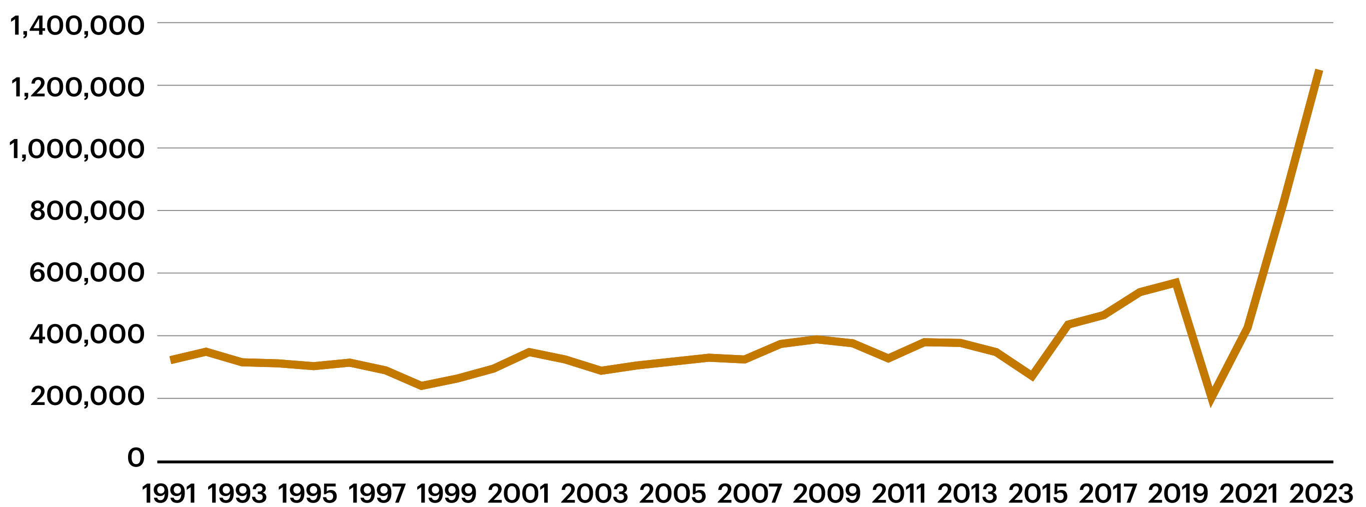
Long-term: Assessing the Income Growth

Long-term income growth is evaluated by taking stock of demand and supply drivers. When demand growth outpaces supply growth, occupancy and income collection increases for existing supply.

Assessing the Demand

From a demand perspective, Canada is witnessing unprecedented population growth, as shown in **Figure 4**. This is nearly the equivalent of adding the population of Calgary to the country every year, and they will need a place to live, work, shop, and play. Moreover, Canada's five-year projected population and real GDP growth rate is five times and 50% greater than the G7 average, respectively.[2]

Figure 4: Canadian Population Growth (Year-Over-Year)



Source: Statistics Canada, population estimates, quarterly.

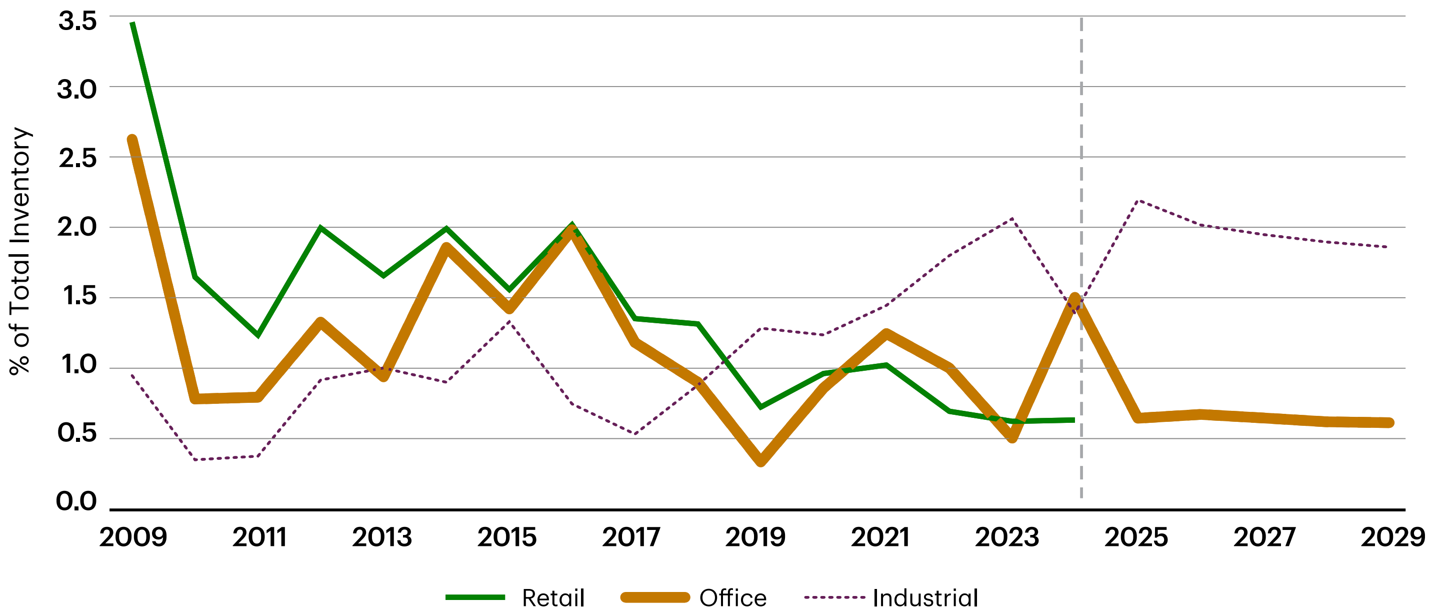
[2]Oxford Economics, June 2023.

Evaluating the Supply

Supply projections are not keeping pace with demand expectations. Importantly, supply cycle turns move slower than demand cycles, and the decision to halt new developments subsequent the pandemic is only now starting to impact markets. Meanwhile, post-pandemic inflation is further stifling new supply.

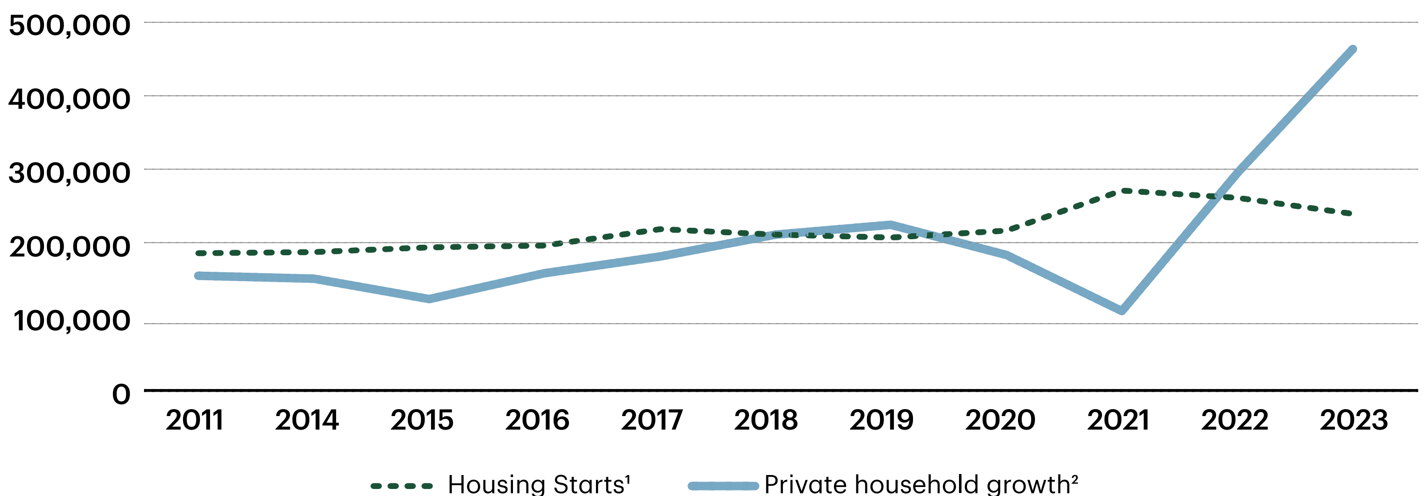
Industrial is budgeting new supply but it could be less than required due to current near-record low vacancy. Within office, virtually all recent new supply has been the product of decisions made pre-pandemic when major Canadian office market vacancy levels were near record lows. The building cycle is coming to an end, however, with near zero new supply coming in 2025 and thereafter. Multi-unit residential towers also have significant time lags between the decision to build and the actual space coming to market, which is augmenting Canada's anemic housing supply response to its burgeoning need, as shown in **Figure 6.**

Figure 5: Commercial Real Estate New Supply



Source: CBRE. No retail forecast available.

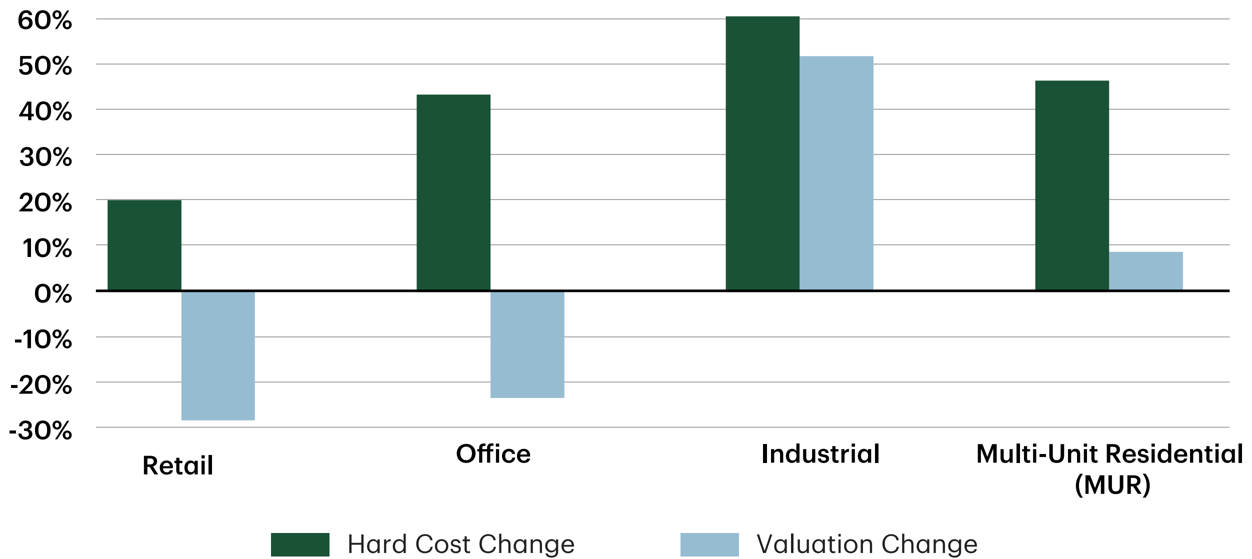
Figure 6: Housing Supply Falling Despite Need



Source: [1]Statscan. [2]Oxford Economics, 2021-23 are forecasted values.

Unlike other asset classes where technological disruption reduces cost-of-supply, real estate building costs have a linear relationship to the cost of land, labor and materials (inflation). Post-pandemic, hard building costs (e.g. labor, materials) have increased substantially while valuations, apart from industrial, have significantly lagged, as shown in **Figure 7.** This can deter new supply and can increase the expected occupancy and income levels of existing space over the long term.

Figure 7: 2024 vs. 2019: Building Cost Increases Outpacing Valuation Changes



Source: Altus Group, Hard Costs per square foot of top three metro areas. Valuation change according to MSCI Canada Property Index. Dec 31, 2023 vs. Dec 31, 2019. Bloomberg Financial.

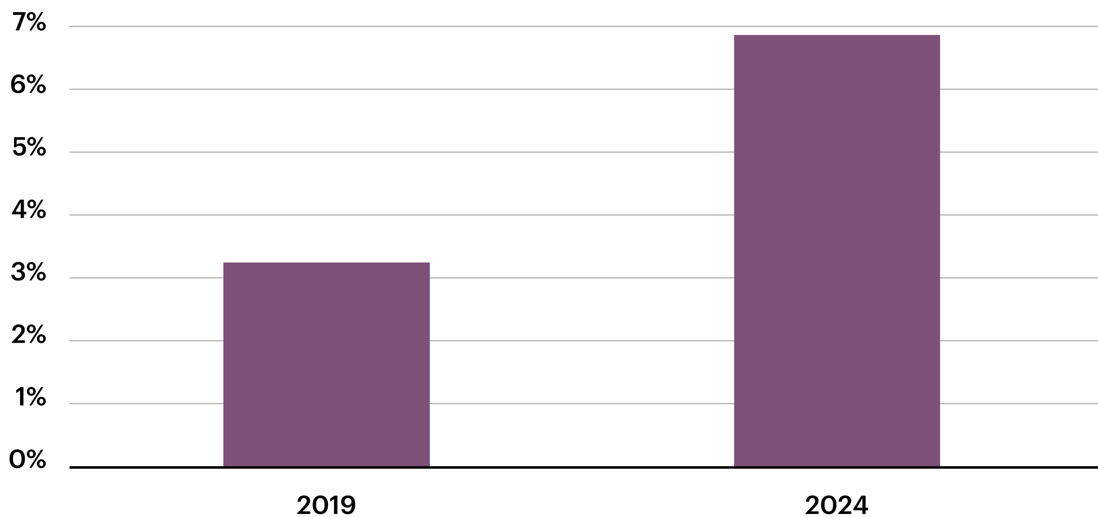
Overall, long-term demand and supply dynamics are indicating robust income growth within Canada. That said, cap rates are more difficult to predict and the inverted yield curve has been suggesting a potential recession for nearly two years. Commercial real estate portfolios with a focus on quality and an overweight allocation in multi-unit residential are well-positioned to weather potential cap rate or economic turbulence and participate in attractive long-term supply demand dynamics.

Protecting Value and Growing Income Today

A focus on quality can deliver sustainable income through difficult markets. If overall demand slows, vacancy rises and tenants gain more options. In this scenario, higher quality space dominates the overall demand pool as tenants 'trade up' in terms of quality. The COVID-19 office shock is a prime example of this as the incremental vacancy in Class B office versus Class A has more than doubled since 2019, as shown in **Figure 8**.

As was displayed in 2022 and 2023, sustainable and growing income streams can defend against further pressures on cap rates. Multi-unit residential is providing both characteristics, with embedded rent growth of 40% and 34% in Toronto and Vancouver, respectively (24% Nationally), while multi-unit residential income valuations (cap rates) are less susceptible to economic and real estate market pressures.[3] This was demonstrated during the Global Financial Crisis, where commercial property cap rates expansion was nearly double that of multi-unit residential and this pattern is being displayed again in today's reflationary environment.[4] This is a result of necessity-based demand for multi-unit residential and warrants a significant allocation at any time of the cycle.

Figure 8: Flight to Quality Within Office



Source: CBRE. As of Dec 31, 2019 vs. Dec 31, 2023.

[3] CMHC October 2023 Household Survey.

[4] CBRE.

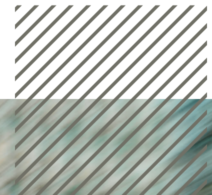
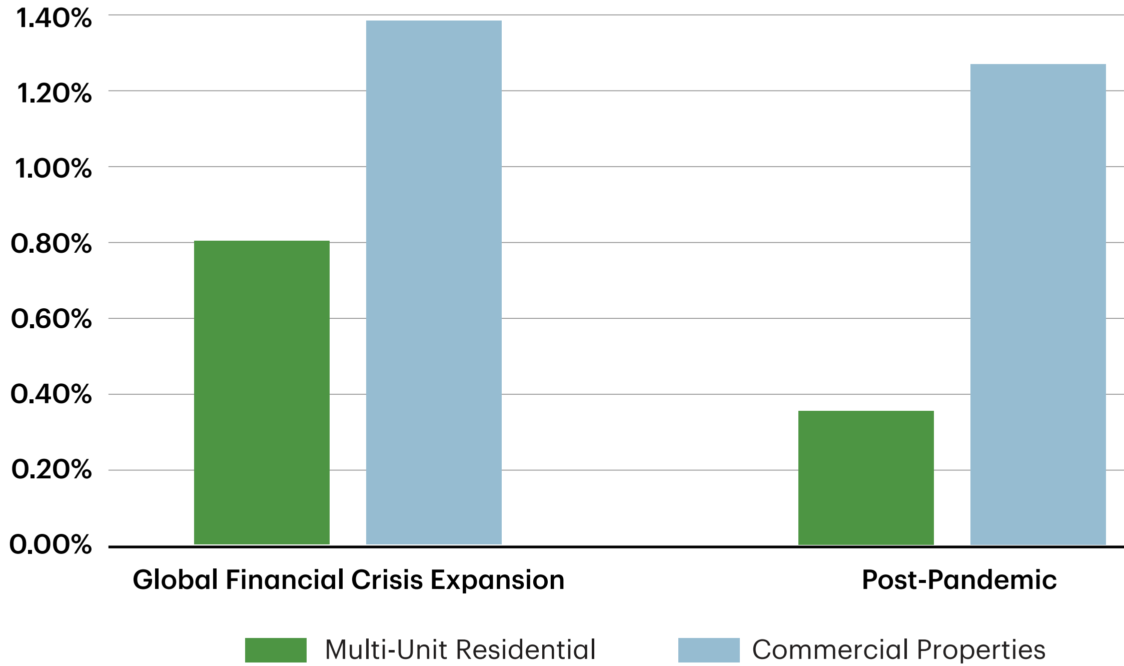


Figure 9: Cap Rate Expansion: Multi-unit Residential vs. Commercial



Source: CBRE. Global Financial Crisis is June 2007 – September 2009. Post-Pandemic is March 2022 to December 2023. Commercial properties is simple average of retail, industrial and office.

Summary

Canadian commercial real estate witnessed the largest relative cap rate increase since the Global Financial Crisis while delivering resilient performance due to the income profile of the asset class. While cap rates could witness continued near term pressure if fears of economic contraction and interest rates rise further, the historical move higher in cap rates is indicating an attractive entry point for investors. Longer term, unprecedented population growth and limited new supply is driving up expected occupancy and income levels of the asset class. Investors that are heavily focused on defensive property types, such as multi-unit residential, needs based retail, and quality, such as Class A building with strong ESG characteristics, are poised to better weather any cap rate and economic pressures and capitalize on robust real estate returns in the post-pandemic era.

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