Top 10 Real

INSIGHTS

2018 RealREIT

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1. CANADA ACTIVIST FRIENDLY

Shareholder Activism on the Rise in the REIT Sector

"Canada is the most shareholder activist-friendly jurisdiction in the Western world," said Walied Soliman, chair of law firm Norton Rose Fulbright Canada. Regulations are more conducive to activism in Canada than in the US for three main reasons: says Victor Guo, Executive Vice President of Governance Special Situations, Kingsdale Advisors:

- The Canada Business Corporations Act stipulates that the holders of not less than 5% of the issued shares of a corporation, that carry the right to vote at a meeting sought to be held, may requisition the directors to call a meeting of shareholders for the purposes stated in the requisition.
- The trigger for the early warning reporting requirement is the accumulation of 10% of the voting or equity securities of a reporting issuer, twice the US level.
- Shareholders are allowed to solicit proxies to 15 or fewer shareholders privately, or/and by way of public broadcast, speech or publication, not necessarily through a dissident circular, which may appear appealing to run a proxy contest from the perspective of costs.

A McKinsey & Company study found that, although 75% of activist campaigns began collaboratively, half eventually turned hostile. Campaigns tend to become hostile if the activist's objective is a change in governance or legal matters, such as revisions to bylaws, for example, rather than strategic or M&A-oriented proposals, McKinsey reports.

Canadian REIT activism has been on the rise in recent years, according to figures from Activist Insight, even as activism in the broader Canadian market has dropped after peaking in 2015.

"The level of activism we're starting to see in the Canadian REIT sector is unprecedented," said Wes Hall, executive chairman of proxy and M&A services firm Kingsdale Advisors.

Sandpiper and FrontFour, the activists that succeeded at making board changes at Granite REIT, remain at the forefront of REIT activism in Canada.

According to the report Proxy Season Review 2017 prepared by Kingsdale Avisors, although the number of public proxy contests undertaken in Canada may be on the decline activism is still having a significant impact on Canadian Companies

At the time the report went out, there had been 20 proxy contests, down from 33 in 2016 and 55 in 2015 but that the battles don't always become public spectacles. Instead companies and activists "are finding new ways to work more constructively behind the scenes to realize what both hope to be value enhancing solutions, while saving public reputations and corporate funds."

Parties on both sides (targets and activists) are settling sooner than they were in the past, says Bradley Freelan of Fasken in Toronto. This means that fewer fights become formal proxy contests, "which are very expensive and time-consuming for management. There's good incentive for both parties to want to work out a deal," he says.

Generally, the settlements give activists seats on a board of directors, while an early settlement may mean an activist "agrees to take fewer seats than they asked for, in agreement for not circulating proxies," Freelan says.

2. REITS & THE RISE OF INTEREST RATES

Does the hike in interest rates spell trouble for REITs?

As interest rates rise, REITs start to look relatively less attractive versus fixed-income alternatives.

However, REITs tend not to suffer if the interest rate hikes are a result of a strong economy that is helping real estate fundamentals. When the US Fed began raising rates in 2004, the REIT market dove 15% but proceeded to rise 78% in the face of 17 rate hikes by the Fed over the next three years, according to Forbes.

Furthermore, the threat of rising interest rates hasn't deterred several REITs from tapping equity markets this year. More than $1 B (US) was raised in Canada in the sector through June 20, slightly less than the $1.2 B raised during the same period in 2017, according to data compiled by Bloomberg.

In April, BSR REIT raised $135 M. This was followed a $175 M secondary sale by Dream Global REIT and a $260 M equity raise by Allied Properties REIT in June.

Minto Apartment REIT is also tapping Canadian equity markets this year, raising $200 M in its initial public offering.

Summit Industrial Income REIT Announced Completion of $115 M Equity Offering on June 15. The REIT intends to use the net proceeds from the Offering primarily to fund the acquisition of a 100% interest in five warehouse and logistics properties located in Markham, Burlington, and Calgary. The properties total approximately 798,673 SF of GLA for a total purchase price of approximately $127.0 M.

3. RETAIL APOCALYPSE NOT IMMINENT

Retail Sector shows signs of health with influx of new brands & expansion of established chains

According to CIBC's REIT Report, while the negative sentiment surrounding the space is undeniable, and readily apparent in the significant relative underperformance of retail-oriented REITs, the actual operating performance have actually been among the strongest in the entire Canadian REIT space, with 2017 Y/YFFO growth averaging close to 4% against an industry average of -2%.

On the whole, the retail market is benefitting from the real GDP growth of over 3% in 2017, which is resulting in strong consumer spending.

However, Edward Sonshine, CEO of Riocan stated that more than income growth, population growth has the biggest impact on retail spending. This is one of the reasons for Riocan's $20 B divestiture out of the secondary markets.

A host of new brands are expanding into the Canadian market while other brands are looking to increase the number of their locations.

MUJI's Canadian President, Toru Akita, said that he expected MUJI to operate between 15 and 20 stores in Canada by the year 2020. The retailer has 8 locations in the GTA and GVA.

UNIQLO has announced that it will open four stores in Canada in the fall of 2018 doubling its current number of locations. It is ramping up its Canadian expansion that could see as many as 100 stores open over the next several years.

Australian eyewear retailer Bailey Nelson hit the Canadian market last fall. North American managing director, Bree Stanlake noted that Canada could see as many as 40-50 Bailey Nelson stores open over the next four years. Stores will be in the 1,000 SF to 2,000 SF range.

Chinese dollar store MINISO plans to open 500 stores in Canada.

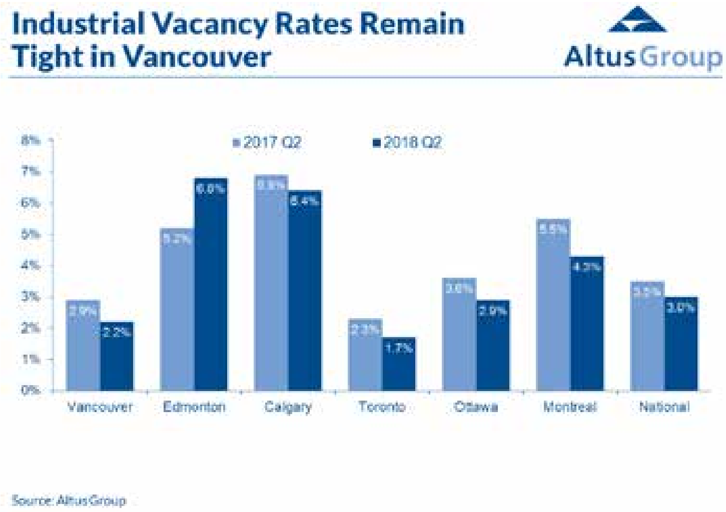
DSW Designer Shoe Warehouse opened three stores in Canada this spring, bringing its Canadian store count to 27 units nationally. Of the three new locations, two stores are located in Ontario, and one in suburban Edmonton. DSW's COO said that Québec will be a target for the company as it continues to grow its brick-and-mortar operations.

- La Maison Simons, is in the middle of a 5-year $200 million expansion, which includes new stores in Vancouver, Edmonton, Calgary and Toronto backfilling vacant space left by large retailers Sears & Target.
- Maison Simons will be opening up a new store at the Fairview Pointe Claire shopping mall in 2021. It will be taking over space that Sears has vacated.
- The expansion also includes its first net zero energy store in the space formerly occupied by Target in the Galeries de la Capitale in Québec City.

According to a report by Deloitte, revenue growth in the past five years of low-priced retail outlets like Old Navy has grown by 37% while revenue of high end luxury shops have grown by 81%.

Deloitte further reports that 91% of retail sales still occur in bricks and mortar shops in the US. This number is higher in Canada where more than 95% of shopping occurs in retail locations according to StatsCan.

4. INDUSTRIAL SPACE A SCARCE COMMODITY



Demand for industrial space is skyrocketing in all of Canada's major centres.

Cushman and Wakefield estimates that 25 to 30% of industrial leasing can be traced to e-commerce needs. On a global basis, e-commerce concerns take up 20% of new leases, up from less than 5% five years ago, adds industrial real estate and warehouse logistics management company Prologis Inc.

Online retailers on average need approximately 1.2 M SF of space per US $1 B worth of online sales, three times the distribution centre space required for traditional brick-and-mortar retailers, according to Prologis.

The GTA has the third largest industrial real estate inventory in North America with 760 M SF. It trails only Los Angeles at 1.1 B SF and Chicago at 1.2 B SF.

About three of every 10 goods purchased on online are now returned, about three times the rate of in-store returns, said Ben Conwell who is the Seattle-based senior managing director at Cushman and Wakefield and leader of its e-commerce fulfillment division. This produces an increase in demand for warehousing as the returns don't always go back to the distribution centre.

Kevan Gorrie, former chief executive of PIRET and the newly appointed CEO of Granite REIT, stated that "The reverse logistics side is really interesting in that more and more companies are specializing in that and they are taking up more and more space in and around the cities in North America," he said. "It is becoming a standalone business on its own."

Demand for industrial space is skyrocketing in all of Canada's major centres. However, it is not just e-commerce that is fueling this demand, pot is the other sector that is consuming space at a terrific rate.

In Winnipeg inventory remains limited with the vacancy rate of 3.3% dropping to its lowest point in the past five years. A portion of the demand is coming from bitcoin mining companies attracted to the city's cheap electricity. Industry experts say that there are around 20 mining companies that have set up shop in Winnipeg.

Vancouver's industrial vacancy rate is less than 2% despite more than 3.6 M SF of new construction.

In 2017's fourth quarter, more than 722,000 SF of industrial space was sold or leased in the GVA, and prices have hit record highs.

According to Cushman and Wakefield, industrial rents have increased by 15% from 2016 averaging $10.82 psf.

In Edmonton at the end of last year, the cannabis industry alone absorbed over 200,000 SF of industrial space in two significant transactions and is expected to have a continued impact on this sector.

- Aurora Cannabis 800,000 SF production facility will open this year
- Canopy Growth is retrofitting a 160,000 SF facility in the Morris Industrial Park
- Freedom Cannabis is converting a 125,000 SF facility in Acheson.
- RavenQuest BioMed is renovating a 35,500 SF structure in the Northwest Industrial Area.
- Pebble Grass is renovating a 25,000 SF building in South Edmonton.

5. BLOCKCHAIN: REAL ESTATE'S LATEST DISRUPTER

This technology, which manages and validates online data, has the capacity to revolutionize the real estate industry.

Blockchain is the digital and decentralized ledger system that records all transactions. Instead of a central hub where transactions are stored, servers and hard drives all over the world hold blocks of data. Blockchain uses cryptography to ensure that the data cannot be counterfeited or changed. Miners validate transactions on blockchain networks and get paid in cryptocurrencies.

First used by bitcoin, this technology has many real estate applications.

Smart contracts

The provisions of an agreement between the two parties are written into lines of code. The monetary component of the contract can be embedded into a smart contract. This reduces the need for intermediaries and permits the transaction to be carried out between anonymous parties. Lease agreements when conducted using a smart contract can be signed and verified directly between the landlord and tenant.

In February, SMARTRealty launched an ICO. SMARTRealty is building a smart contract template and management system that can be used with all common types of real estate transactions. It can also be used with real estate rental and property sales platforms that interact with all the major real estate listing services on the web.

MLS

Since blockchain is essentially a decentralized database, the potential exists for the MLS system to be replaced by it. Through the validation process of the 'miners', listing data would become more accurate, it would be in real time and it would be de-commoditized.

Land Titles

Many land title offices in Canada and around the world are still paper based. When a property trades, it takes weeks and sometimes months before the transaction is registered on title. In some countries, this process is vulnerable to loss and corruption.

Governments have begun to test the use of blockchain for transferring and tracking property titles and other public records.

Chicago's Cook County registry office is the second largest in the US and in 2016 it started testing blockchain technology. The office began testing blockchain applications of property title transfer and a system for filing liens; compatibility between a blockchain and a traditional, server-based setup; fraudulent use prevention and conveyances of vacant property in Chicago.

Other pilot projects are taking place in Vermont, Stockholm, Ghana and in the Republic of Georgia.

6. SECONDARY MARKETS – NECESSITY OR UNNECESSARY RISK?

As primary markets post record asset prices, REITs are choosing to invest into secondary markets while others are divesting out of them.

Riocan divesting out of secondary markets to focus on markets that have increasing population that will fuel retail spending.

In the past year, Allied REIT exited out of the Victoria, Winnipeg & Quebec City markets to focus their operations in Canada's largest cities.

However, a shortage of industrial land in Vancouver is forcing development into secondary markets such as Chilliwack and South Surrey.

Canada's major cities are posting record asset prices; there is more room for value creation in secondary markets.

According to NAREIT, in the US, REITs began shifting their property portfolios into secondary markets as early as 2013. Solid economic fundamentals, in particular the increases in population and employment, have driven the growing demand and occupancy rates within secondary markets.

Since 2012, REITs have increased their holdings of office properties in secondary markets by almost 30 M SF, while REIT positions in primary markets were essentially unchanged and their holdings in tertiary markets fell.

Colliers noted in its 2018 property outlook that sales and leasing volumes have been shifting (and will continue to shift) to secondary locations due to decreasing availability and progressively pricier rents in the primary markets.

Beyond asset pricing, secondary and tertiary markets have a lower cost of doing business. According to IHS Markit, average costs in secondary markets are 16% lower. "This is especially acute in real estate and energy costs where the secondary markets are 38% and 22% lower respectively".

7. NO PLACE TO LIVE

Essential city workers can no longer afford to live in Canada's two largest cities.

RBC's latest affordability study released in July shows that housing in Vancouver and Toronto has hit crisis levels. In Vancouver, it would take 88% of an average household's income to buy a house. In Toronto, it would 74% of an average household income would be required to cover the costs of home ownership. The Canadian average is about 48% and in Calgary and Montreal, it is lower than 44%.

While home ownership becomes out of reach for many households in Canada's two largest cities, rental rates have also gone through the roof.

At the end of last year, the CMHC reported that the average rental rate for a one bedroom purpose built apartment unit in the GTA was at $1,191 and the rents that are charged for condos was a lot higher at $1,789.

"It is worse than it looks from these figures," says Kenn Hale of the CMHC numbers. Hale, director of advocacy and legal services at the advocacy centre, continues, "these are not the average rents of units that are available, these are average rents of units that are occupied."

Indeed, in Q1 2018, the average rent for one-bedroom condominium apartments in the TREB market area was up 11.4 % on an annual basis to $1,995. The average two-bedroom condominium apartment rent was up by 9.1% over the same time period to $2,653.

Lack of affordability is bad for employers, making it difficult for them to attract and retain workers in the urban core.

As an example, 83% of Vancouver Police Department officers do not live in the city of Vancouver.

A 2012 study of the Hospital Employees' Union (which has 49,000 members) revealed that 25% of its members spend an average of one hour and 20 minutes a day behind the wheel, while those on public transit spend an average ride of 2.5 hours.

Schools on Vancouver's pricier west side have a harder time filling positions. And the projected closure of more than a dozen Vancouver public schools points to the fact that families can no longer afford to live there.

In Canada's largest cities, qualified job candidates are deterred from moving to the city and great employees are leaving because they can't afford to build a life there.

Interest in secondary markets is growing. New home sales in the Greater Golden Horseshoe (GGH), outside of the GTA, have moderately increased since Q1 2018, while prices remain lower than the GTA. The Hamilton and Waterloo regions have gained notable traction in new condo sales as plans for expansions in transit move forward and regional concentrations of economic activity pick up.

The crisis has goaded the government into action. The feds announced a national housing strategy last fall that commits $40 B over 10 years to new purpose built rental units, upgrades of aging properties. It also includes loans to encourage developers to build new housing geared toward modest- to middle-income families.

Ontario's Provincial Affordable Housing Lands Program has spurred the development of 2,200 new rental units in Toronto:

This Spring, Greenwin and CREIT formed a partnership to build 700 new purpose built rental units in the area of Yonge and College in Toronto. The two building development is part of the first phase of the Provincial Affordable Housing Lands Program and will include 210 units that will be designated affordable for 40 years.

Another JV will see Dream, Kilmer & Tricon develop and manage a rental apartment community of about 1,500 units in Toronto's West Don Lands. The partnership was selected through a marketed offering to sign 99-year land leases with Infrastructure Ontario to construct the rental units, retail and potential office space. Dream, Kilmer and Tricon hold equal ownership shares.

8. DEMAND FOR CO-WORKING SPACE INTENSIFIES

Shared office space could account for as much as 20% of the overall office market in Canada within the next decade, per a new Cresa study.

According to a recent study published by Cresa , there is one million SF of co-working space at 85 locations. In Vancouver there is 790,000 SF in 59 locations. Toronto's downtown core has 69% of the locations while Vancouver's core has 56%.

The following companies comprise approximately 87% of the co-working space in Toronto: iQ Office Suites, Workplace One, Regus, WeWork, Workhous, Office Exec, Brightland, Sentre for Socical Innovation and The Fueling Station.

Spaces, an Amsterdam-based shared space company is set to open 3 locations in 2018 in Gastown, Granville and Mt. Pleasant, totaling 145,000 SF and opened a 46,000 SF location on John Street in Toronto in November 2017. Spaces has 60 locations in 25 countries.

Spaces itself was acquired in 2015 by Regus, an office sharing giant that offers more traditional short-term workplaces in office towers and suburbs, with 41 locations in Toronto alone and nearly 600,000 SF of space.

WeWork, The New York-based company aims to occupy at least 20 different locations in Toronto by 2020, up from three now. When WeWork opened its first two locations in the city last year, both were 98% occupied within the first month. A third location was announced in January of this year.

Last October Hudson's Bay Company (TSX:HBC) sold off its storied Lord & Taylor property in the heart of New York City to a joint venture between WeWork Inc. , and private equity firm Rhone Capital. As part of the $1.6 B deal, HBC will also lease out office space in its other locations, including floors of its downtown Toronto and Vancouver stores.

Even before the Lord & Taylor purchase, WeWork was the 11th-largest tenant in New York City, with over 2.1 M SF of office space, surpassing Goldman Sachs, according to a recent PwC report.

One of the biggest drivers of this trend is the emergence of millennials in the professional world. 3invest reports that of the nearly half a million-people working remotely in coworking spaces around the world, 65% of those people are millennials.

Forbes cites the following reasons why millennials prefer co-working over traditional office configurations:

- Memberships cheaper than leasing
- Fewer responsibilities related to maintenance
- Networking opportunities
- No need to commit to lengthy lease term
- Ideal for startups
- Urban-centric locations
- Resistance to traditional office format

9. STEADY INVESTMENT ACTIVITY

In the last 12-month period, REITs have been divesting non-core assets

Recently, Cominar REIT has just sold 95 of it non-core market portfolio to Slate for $1.14 B. Cominar's plan is to focus on its core markets portfolio in Montreal, Quebec City and Ottawa.

Allied Properties REIT sold its portfolio of six properties in Québec City for aggregate proceeds of $24 million. The portfolio was comprised of 224,174 SF of GLA. As at September 30, 2017, it was 60.8% leased.

The largest transaction of the year was the sale of Allied Properties REIT's Winnipeg portfolio to an out-of-province investor. The portfolio consisted of five properties with a total rentable area of 343,083 SF, which included four Exchange District heritage office buildings, and a multi-tenant industrial property located at 1500 Notre Dame Avenue.

Approximately 100 of RioCan's properties are to be sold in phases over the next two to three years. This represents over $2 B of income properties primarily located in Canada's secondary markets, including certain non-core assets in major markets.

Granite REIT announced in July that it has entered into an agreement to acquire a warehouse and logistics property in Erfurt, Germany consisting of approximately 717,000 SF of gross leasable area. The purchase price of euro 53.9 M represents an in-going yield of approximately 5.4% excluding transaction costs. The property is located in one of Granite's core European markets and builds on Granite's existing presence in the German logistics market.

In November, BTB REIT acquired the retail power center known as the «Carrefour Saint-Romuald» in Lévis, Québec. This $35.9 million transaction total leasable area of 121,000 square feet and is entirely leased. It houses well-known national retailers such as Archambault, Avril, Michaels, Bulk Barn, Mondou and Latulippe.

10. DIVERSIFICATION OR SPECIALIZATION

The REIT spectrum ranges from highly specialized to diversification to grow their operations

Earlier this year Choice Properties REIT acquired Canadian Real Estate Investment Trust for approximately $3.93 B. The acquisition diversifies their portfolio by adding more industrial and office space to its retail portfolio.

Choice Properties CEO John Morrison said one of the growth opportunities for the enlarged REIT will be a collection of about 60 properties ripe for mixed-use development, including 48 from Choice. The merger will allow Choice to diversify away from its retail focus.

A Calgary investment firm is launching one of Canada's first cannabis real estate investment trusts.

CBi2 Capital announced this week investment in Industrial Lifestyle Properties Real Estate Investment Trust (iLP) which will acquire, develop and manage cultivation facilities, industrial properties and real estate for the cannabis industry.

Alignvest Management Corporation announced in July the formation of Alignvest Student Housing Real Estate Investment Trust, an investment vehicle focused exclusively on consolidating the highly-fragmented Canadian Purpose-Built Student Accommodation ("PBSA") real estate sector. ASH REIT has launched with over $65 million of capital commitments.

ASH REIT is scheduled to close on the purchase of its first PBSA asset at 181 Lester Street in Waterloo, Ontario, in July 2018. This asset is a 455-bed (18 story) high quality purpose-built building that is over 98% leased for the upcoming school year, and strategically located between the University of Waterloo and Wilfrid Laurier University.

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