<u>The Impact of the Global Financial Crisis on Investments in Commercial Real Estate: A Canadian Perspective</u>

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The turmoil, volatility and uncertainty that have been characteristic of world financial markets over at least the past year and a half have not spared the Canadian economy or, more particularly, the Canadian commercial real estate market.

Canada was one of the last economies to succumb to the pressure exerted by market forces but the impact has not, so far, been quite as severe as that experienced in other parts of the world. A quick and sudden downturn in global commodity prices, which had been at record levels in the past few years, and a slowdown in the manufacturing sector have contributed to the recent decline. In addition, the economic malaise in the United States, Canada's largest trading partner, has had a depressive effect on the Canadian economy. However, economists and market analysts point to a number of mitigating factors, including Canada's strong banking system, that may be softening the blow that Canada and its real estate market have had to absorb from forces that have crippled economies and once venerable and robust financial institutions worldwide.

This brief paper will look at the impact of the shortage of liquidity in capital markets on investment in Canadian commercial real estate.

Canadian Banking System

The Canadian banking system is dominated by five large domestic "chartered" banks, all of which were founded in the 1800s. There are also a number of smaller banks and credit unions playing a large role in the market.

Canadian banks are regulated by the Federal Government (as distinguished from the various provincial governments), leading some to suggest that this creates a more cautious culture of lending. Fairly stringent banking regulations, combined with what economists and other commentators have called a "conservative" approach to lending and loan underwriting, have contributed to what the World Economic Forum called, in late 2008, the "soundest" banking system in the world.[2] There have been no failures of domestic financial institutions or government bailouts occasioned by the global credit crunch, nor has there been a mortgage "meltdown": to date, domestic commercial and residential loan default levels in Canada have been low. To support Canadian credit markets, the Federal Government has announced its plan to purchase of CAD$75 billion of pools of insured residential mortgages from domestic lenders under its "Insured Mortgage Purchase Program". Since the underlying loans are not distressed, these fiscal measures are not designed to take "toxic" mortgages off lenders' balance sheets; rather, they are designed to free up capital for further lending.

In summary, while the "Big Five" banks have suffered losses due to write-downs associated with their investments in the United States and elsewhere around the world, to date Canadian financial institutions have weathered the storm in good shape. Due to relative changes in equity values over the past couple of

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[2] World Economic Forum: The Global Competitiveness Report 2008-2009. Canada ranked slightly ahead of Sweden, Luxembourg, Australia, Denmark and The Netherlands. The United States ranked 40th in the survey.

years, Canada's banks now have some of the largest market capitalizations and strongest balance sheets of financial institutions around the world.

Tighter Credit Conditions

Though prime lending rates are low[3], lenders have factored in a much higher risk premium, resulting in jumps in interest rates available to commercial borrowers in Canada. Spreads have increased from 100 to 120 basis points to 225 to 350 basis points. This has not resulted in particularly high overall interest ratesbut Canadian lenders, like lenders around the world, have become much more selective about who they will do business with. Lenders who continue to lend capital can afford to be more selective: with the CMBS/conduit market effectively shut down, there is considerably less competition that any prospective lender faces.

Canadian chartered banks continue to lend directly and through lender syndicates (especially for larger loans), but it has become more "relationship-based". Borrowers who chose to give their banks their borrowing business during the recent boom, though the cost of such borrowing may have been higher, are being rewarded for their loyalty, though underwriting criteria and credit terms are more stringent: lower loan-to-value ratios (usually topping out at a maximum of 65%), greater net operating income coverage, reserves for tenant inducements and capital improvements and often an expectation of full recourse. More significant due diligence is being conducted, with a greater focus being placed on the integrity of the rental income stream rather than on value; unquestionably, lenders' assumptions about future property values have moderated significantly. Funds are not available for borrowing in every market for every type of project.

Lender representatives, both domestic and foreign, report that though the Canadian real estate-based lending market is still attractive, there is less overall capital available for lending and each bank's customers must compete for scarcer capital with other investment opportunities available to the banks.

The January 2008 elimination of withholding tax on interest payments made to foreign lenders was intended to open up a new source of capital for Canadian investors, but its impact was effectively and quickly neutralized by the offsetting credit crisis. Some offshore lenders are also facing political pressure to lend in their own countries.

One significant concern on both the Canadian and U.S. sides of the border relates to the refinancing of CMBS loans, of which a considerable number will mature in 2011 and 2012. Borrowers have expressed concerns about how their loans will be refinanced if the current economic climate continues. There will likely be defaults associated with an inability of borrowers to meet lenders' more stringent lending requirements at maturity.

Although trite to say, borrowers will want to keep their existing debt facilities in good standing, if on favourable credit terms. The *quid pro quo* for a borrower request to renegotiate loan terms could be re-pricing of the debt, an increase in the interest rate and more stringent covenants.

Capitalization Rates and Re-pricing

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[3] The Bank of Canada cut its overnight rate to 0.5% on March 3, 2009, its lowest rate ever.

In most of the world, excess liquidity in the capital markets led financial institutions and investors to take on more risk than would ordinarily be the case, all with a view to achieving higher yields. Lenders “fought” for financing opportunities, leading buyers to aggressively compete for purchasing opportunities, and, in the process, the underlying risk of many assets was not always given the focused and critical evaluation that prudent lenders and buyers might ordinarily give to potential investments.

Now money is no longer “easy” to come by and risk is being re-evaluated and re-priced across all market sectors. In the Canadian real estate market, this has resulted in returns from commercial real estate falling from 15.8% in 2007 to 3.7% in 2008.[4] Capitalization rates have increased by 100 to 200 basis points, depending on the market. What has been striking is the remarkably short period of time during which re-adjustments in market expectations have been forced to occur. This has pushed the Canadian real estate market into disequilibrium: lenders and institutional investors are sitting on the sidelines waiting to see how things evolve amidst volatile market conditions. Investment volume for 2008 amounted to CAD$17.7 billion, down 44.8% from the CAD$32.2 billion seen in 2007.[5]

Meanwhile, owners of real property, who may themselves have purchased at the peak of the market, are coming to grips with falling property values and rising capitalization rates. This has inevitably resulted in significantly lower levels of market activity: both deal size and the volume of transactions have decreased. In Canada, we are only at the beginning of this shift in pricing. This has led some Canadian private equity investors to look abroad, including the United States, where values have already dipped sharply and quickly, providing those investors with returns not yet generally available in Canada.

Equity Investment in Canadian Real Estate

Another factor mitigating, at least in part, tighter credit availability is the greater involvement of equity investing in Canadian real estate. Equity investing accounts for just over two-thirds of the capital structure of commercial real estate holdings in Canada, while it accounts for little more than a third in the United States.[6] Accordingly, the impact of deleveraging that is occurring in markets around the world may be lessened to a certain extent by relatively lower debt levels in Canada.

Entities raising funds in public equity markets, such as Canadian REITs, have seen the cost of equity rise as a result of falling stock markets and large outflows from capital markets. Public market players are not in a position to raise equity, nor to make accretive acquisitions. This, combined with tight credit conditions, has led to a slowdown in acquisitions and is expected to continue for some time.

Canadian pension funds and other institutional investors in real estate are experiencing disequilibrium in their portfolio mixes resulting from sharp drops in their stock portfolios. While stock markets provide up-to-date and instantaneous values for equity investments, real estate investors have not yet recognized re-adjustments in values of their investments, be it through appraisals or sale transactions. Accordingly, some institutions are “over-weighted” in real property. This has led to many institutions slowing down or halting entirely their real estate investment programs until equity markets improve or real estate assets have been “marked to market”.

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[4] Source: ICREIM / IPD Canada Annual Property Index. Office returns in 2008 measured 7.6%, residential returns were 6.4%, industrial returns reached 2.3% and retail returns were -0.1%.

[5] Source: CB Richard Ellis 2009 Market Outlook: Canada.

[6] Source: Perspective on Real Estate 09: Bentall LP, Kennedy Associates LP, January 2009.

Notwithstanding the state of flux, some Canadian private equity funds have indicated they presently have funds available for direct real estate investment, joint ventures and mortgage investment. In many cases, these funds are being pulled outside of Canada by attractive opportunities abroad, including the United States, where some real estate and mortgage loans can be purchased for cents on the dollar. These opportunities have not presented themselves to any significant extent yet in Canada so, for at least the time being and likely the foreseeable future, the cash may follow larger potential returns available elsewhere.

Vacancy Levels

Although Canada's economy has, in many ways, fared better than many in the face of upheaval in the markets, it would be naïve to suggest that any economy could entirely keep outside its borders the collateral damage resulting from the interlinking and interaction of global markets.

One area in which the impact has and will continue to be felt is vacancy levels. Tenants occupying space in buildings across all property categories are taking a hard look at their space needs. With the slowdown in the economy, falling commodity prices, falling consumer spending and confidence and a rise in unemployment rates occasioned by layoffs, demand for office, industrial and retail space is declining. This fall in demand, combined with the rise of a new supply of office space (particularly in Toronto and Calgary) and retail space coming online in the next one to three years, will result in higher vacancy rates in 2009.

One noteworthy paradox of the declining demand for space in the current economic climate is that even though the Canadian operations of a U.S.-based retailer might be successful, some Canadian landlords have been faced with store closures due to bankruptcies of the U.S. parent (*e.g.,* Linens N' Things). Canadian landlords are feeling the impact of what did not begin as a "homegrown" problem, but which has developed as if it were.

The new market reality has landlords forced to devote significant time to managing their existing tenancies. Landlords are beginning to see more requests from tenants for accommodations on rent and other inducements, both under existing leases and upon renewal. Requests for consent to subleases of all or part of a tenant's space are expected to be more numerous.

In summary, net operating incomes are declining and the risk premium that is priced into capitalization rates is increasing. This is having an upward effect on capitalization rates and this is expected to continue.

The Canadian Housing Market

Though the focus of this paper is on the commercial real estate market in Canada, no such discussion would be complete without a mention of the impact of market conditions on the Canadian housing market. This is especially the case given the drastic declines in residential property values in some parts of the United States and Europe. Is Canada experiencing the same declines?

Canada Mortgage and Housing Corporation (CMHC), the Canadian government agency providing homebuyer assistance and insurance to lenders in case of defaults, forecasts new home construction for 2009 to reach 160,250 units, a 24% decrease from the 211,056 new homes constructed in 2008 and the lowest level since 2000. CMHC also foresees a 15% decline in existing home sales in 2009 from sales in 2008, while the average sale price will decrease by 5.2% to CAD$287,900. A 9% increase in sales is forecast for 2010, but with only a modest price increase.[7] Though by no means do these figures provide reason to celebrate, the declines in sales and prices in Canada do not mirror the sharp decreases that have occurred in the U.S. and the U.K.

Residential mortgages remain affordable and available in Canada. Throughout the recent housing boom in Canada, mortgage-lending criteria were generally conservative and there has been no "housing bubble". For a short period of time from early 2006 until the summer of 2008, mortgages with 40-year amortization periods and/or zero down payments were available in Canada, but the Canadian subprime mortgage market was quite small overall. Interest-only mortgages are not prevalent. Mortgages with 25-year amortizations are more common. The rate of residential mortgage arrears remained quite low at 0.33% as of December 2008.[8]

Expectations for the Short Term and Long Term

What follows are a few predictions for the Canadian real estate market for 2009 and beyond:

Transaction levels:

- Capitalization rates will continue to rise with corresponding falls in market values of real property – this might be viewed as a "normalizing" of property yields and risk after a sustained boom period resulting from strong economic growth and readily available capital.
- Many potential purchasers will remain on the sidelines until values fall to a level sufficient to offset their fear of being "first in" to the market and overpaying. This will contribute to an ongoing disequilibrium between sellers' and buyers' expectations on price.
- Properties for sale with assumable financing will be particularly attractive.
- Vendor take-back mortgages will be a more popular way for buyers to finance acquisitions.
- Deal size has shrunk noticeably and with lenders tightly holding onto funds, large portfolio deals will continue to be difficult to finance.
- Domestic and foreign investors, who still view Canada as a very stable environment with quality assets, will look for bargains in the U.S. and U.K. markets that will be difficult to resist.

Sectors:

- Layoffs will have a depressive effect on demand for *office and industrial* space, which will force vacancy rates upward. In Toronto and Calgary, new office construction commenced during the boom will bring a significant supply of new office space onto the market in the next couple of years. This new supply introduced in the face of weakening tenant demand and drastically lower commodity prices will push rents down. The degree of impact on the office market will depend on how quickly the economy recovers.
- With consumer confidence low, *retailers* will face tougher times, although significant retail bankruptcies are not expected. Canada has less retail space per capita and lower household debt levels than in the U.S., which could counteract low confidence, higher unemployment and lower

[7] Source: Canada Mortgage and Housing Corporation.

[8] Source: Canadian Bankers Association. A mortgage is defined as being "in arrears" where payment is 90 days past due.

income growth. Accordingly, the impact on retail rents in Canada might not be as severe as it could be elsewhere.

- The *hotel market*, facing weakening global demand, will experience a sustained period of unpredictable results.
- The *multi-family* sector (*i.e.,* apartment buildings) is expected to fare quite well, as people looking for a home may be inclined to choose renting over home ownership due to economic uncertainty and fear of job loss.

Financing:

- Borrowing from institutions with which borrowers have pre-existing relationships may be the only way to obtain financing from banks until the squeeze on capital loosens.
- While loan delinquencies may be on the rise, lenders may, in the short term, be inclined to give borrowers time to restructure. However, lenders will be quick to remove this indulgence if the incidence of defaults rises significantly.
- Maturity defaults may increase if sources of refinancing cannot be found and tight credit conditions continue.