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# Real Assets Market Report

December 31, 2016



  
GREYSTONE



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3,000 SOLAR PANELS

Over 1,000  
Mega-Watt Hours

of clean, renewable, solar generated  
electricity annually to Memphis Bioworks \*

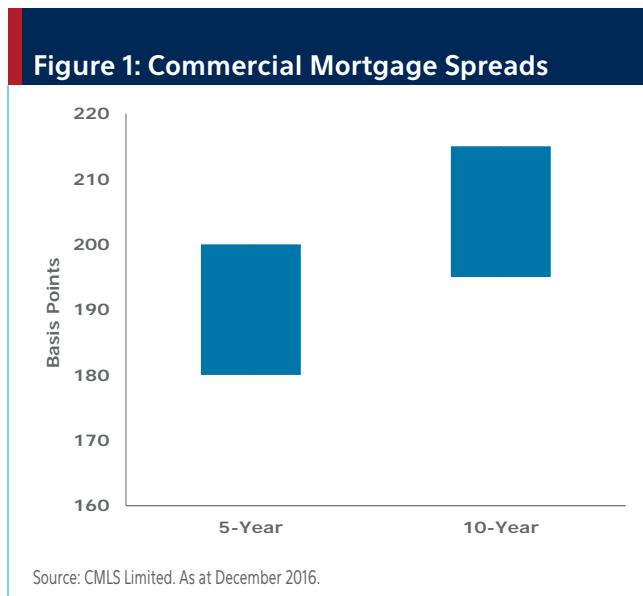
\* Factoid used with permission from Silicon Ranch Corp.

# Investment and Economic Outlook

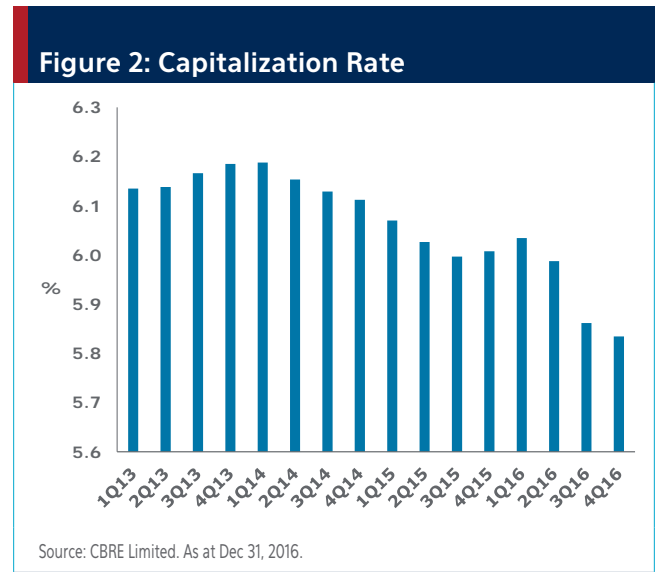
Global central bank policies are evolving away from unending zero/negative interest rates. The U.S. Federal Reserve’s Open Market Committee raised the targeted Fed Funds rate for the second time since the financial crisis and expectations reflect multiple rate hikes for 2017. Following the steps of the Bank of Japan, the European Central Bank now also appears to be managing the difference between short- and long-term interest rates rather than pushing absolute yields lower.

Canada’s economy will likely be supported by higher oil prices, although sustained capital expenditure traditionally lags higher oil prices. While the recovery of oil prices generally coincides with an appreciation of the Canadian dollar, interest rate differentials between the U.S. and Canada could dampen this effect. We anticipate markets and the U.S. Federal Reserve will increasingly acknowledge the need for higher rates in order to help manage inflationary pressures from a tight U.S. labour market. In contrast, the Bank of Canada will likely remain on hold as economic growth in Canada is expected to remain at modest levels.

Canadian commercial mortgage spreads (over Government of Canada (“GoC”) bond yields) are currently priced between 180 – 200 basis points (“bps”) for five-year maturities and 195 – 215 bps for 10-year maturities. Capital from both domestic and foreign lenders continues to be available.



The average national capitalization rate (“cap rate”) has compressed for core income producing properties in major markets. The average cap rate fell 17 bps since the start of 2016 to end the year at 5.83%. Major markets such as Vancouver and Toronto have seen the largest decline in cap rates (a decline in cap rates implies an increase in valuation).



Within the narrower confines of the infrastructure sector, 2016 will be remembered for record-breaking fundraising, particularly in the large-cap space, reflecting the attention infrastructure is attracting globally. Notable global trends that were constructive for the sector included broader acceptance of the need for private investment in public infrastructure in North America, and more aggressive renewable energy targets for the European Union.<sup>1</sup>

Memphis Bioworks  
Tennessee, USA



<sup>1</sup>2030 Energy Strategy, European Commission, 2016.

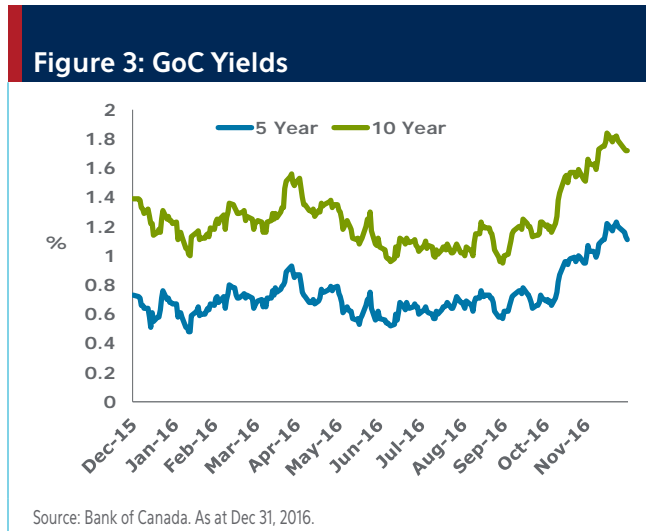
Bay Adelaide Centre  
Office, Toronto, ON

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# Canadian Commercial Mortgage Market

A rise in GoC bond yields has occurred since the recent U.S. presidential election. As of year-end, 10-year GoC yields are at 1.72%, 72 bps higher since the start of the fourth quarter (See Figure 3).



Commercial mortgage spreads over GoC bond yields have decreased by 5-10 bps over the quarter (See Figure 4). However, spreads are currently at the level seen at the close of 2015.

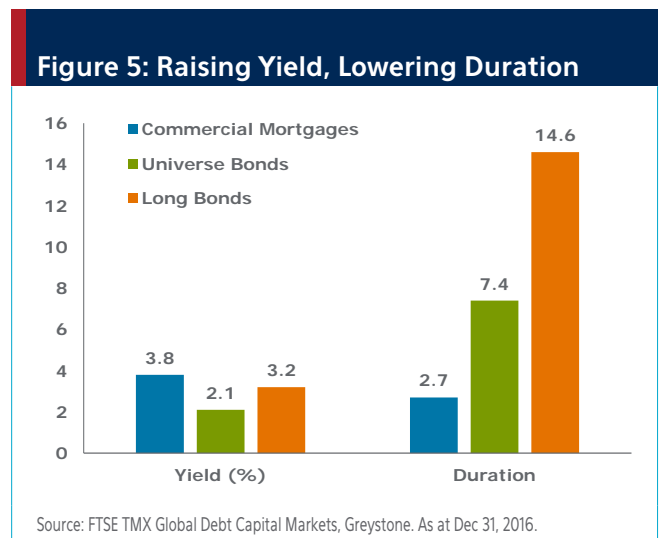
**Figure 4: Commercial Mortgage Spreads**

	5-Year	10-Year
Dec 2015	180-200	195-215
Mar 2016	195-220	210-235
Jun 2016	185-210	200-225
Sep 2016	185-210	200-225
Dec 2016	180-200	195-215

Source: CMLS Financial. December 2016.

CMLS Financial concludes that the slight decrease in commercial spreads is likely due to a renewed increase in lending capital available as lenders were looking to fill their remaining allocations before year-end.

Given current low and somewhat volatile GoC bond yields, we believe that it is prudent to maintain a low duration position (duration measures the sensitivity of a security to a change in interest rates). Direct commercial mortgages have a low duration profile while generating an attractive yield relative to more traditional fixed income securities with a similar duration. The private nature of the asset class and opportunities to invest in variable rate mortgages provide the ability to lower the duration of a commercial mortgage portfolio while enhancing yield.



Overall, commercial mortgages will continue to be available for quality borrowers.

175 Bloor Street  
Office, Toronto, ON



151 Bloor Street  
Office, Toronto, ON

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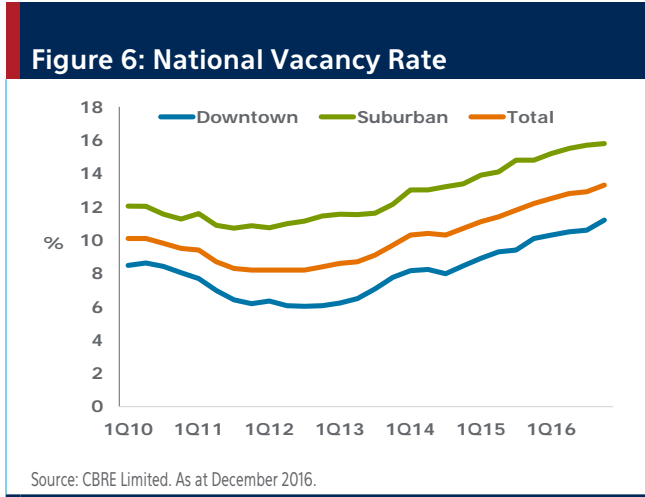


Audi Q3

# Canadian Commercial Real Estate Market

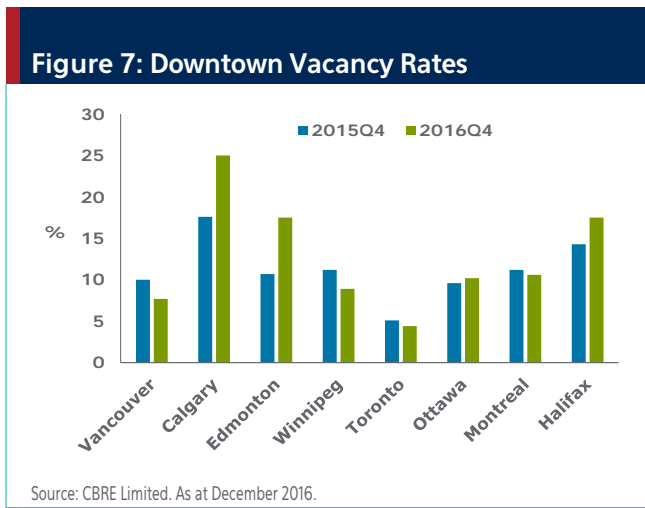
## Office

Vacancy rates for the Canadian commercial office market as of year-end are 13.3%. This is an increase of 110 bps from the previous year (See Figure 6).

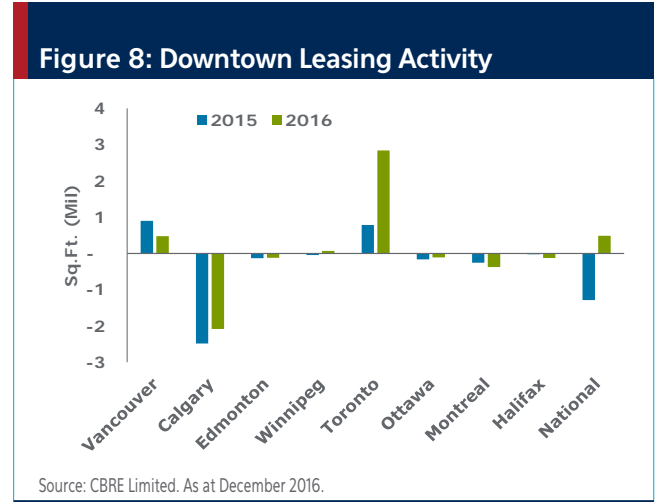


Vacancy rates in downtown markets remain lower than in the suburban markets.

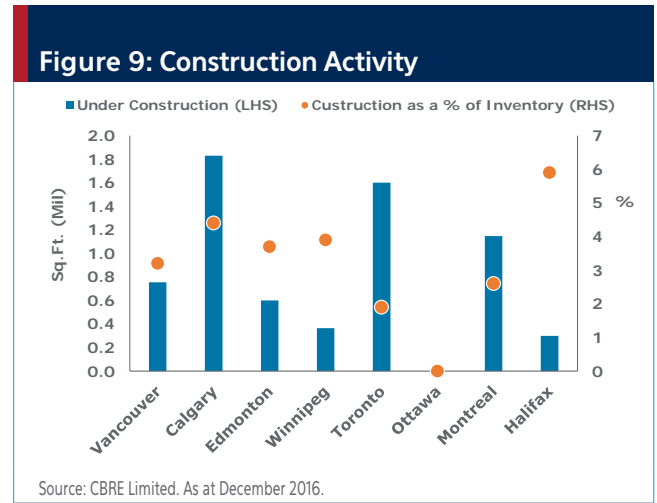
Geographically, downtown Toronto continues to be the best performing office market with vacancy rates at 4.4% (See Figure 7).



In 2016, Toronto had 2.8 million square feet of positive leasing activity, followed by Vancouver with 474,470 square feet (See Figure 8).



Fundamentals in the Alberta market are still weak given the low commodity prices and the amount of new supply expected to come to market.



Landlords with near-term lease expiries are likely to see increased leasing costs, tenant inducements (i.e. free rent), rental rate contraction and higher vacancies. However, the Alberta market (particular the downtown Class A office market) has a lot of well capitalized, institutional quality landlords with long-term investments horizons. This should provide some stability for the Alberta office market.

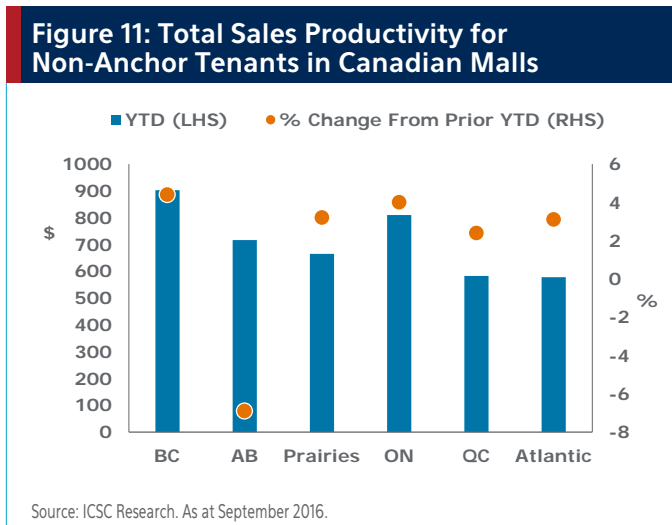
# Canadian Commercial Real Estate Market

## Retail

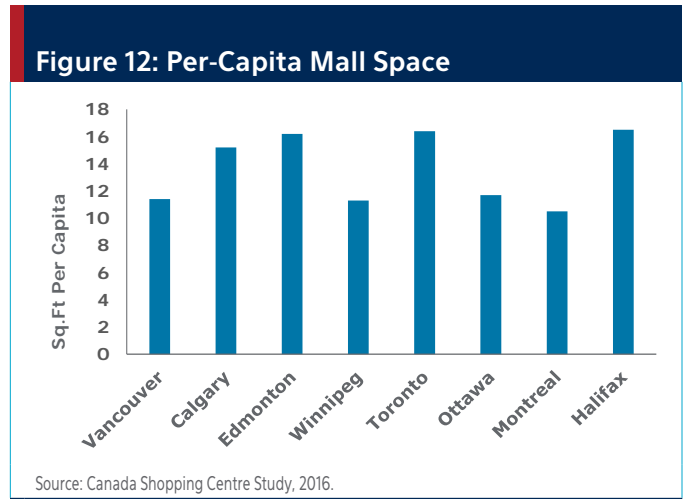
The national retail market remains stable. Vacancy rates are at 4.6%<sup>2</sup> (Q2-2016), a decrease of 10 bps from the start of the year. Current vacancy rates are also below the historical average (1997 – 2016) of 5.1%.<sup>3</sup>



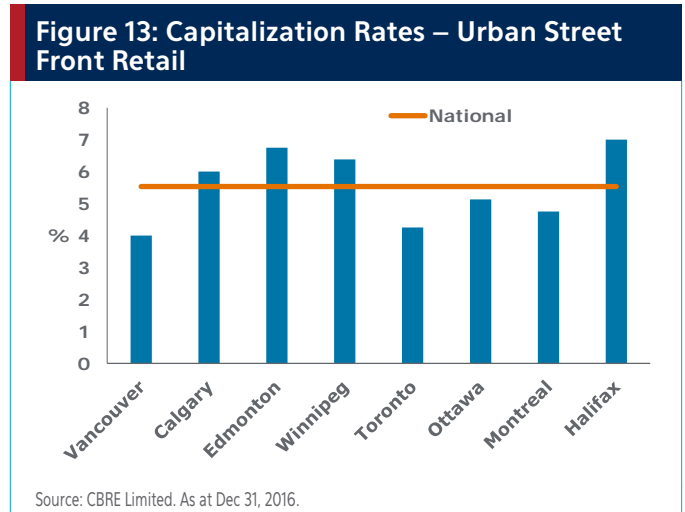
Sales productivity continues to be strong for most markets across Canada. British Columbia leads all provinces with \$903 of sales per square foot, followed by Ontario at \$810.<sup>4</sup>



Despite the strong dynamics in British Columbia, there is a lack of space in the Vancouver market. Per-capita mall space in Vancouver is currently below that of Calgary, Edmonton and Toronto.



With the lack of space and current demographic trends in Vancouver, demand from both domestic and foreign tenants is expected to continue.



As a result of limited supply, current pricing for core properties in Vancouver is at an all-time high. Landlords who have strategic land banks (undeveloped land) are in a better position to build up their core weightings at attractive yields (build-to-core strategy).

Uptown Mall  
Retail, Victoria, BC



<sup>2</sup> Conference Board and CSCA. As at June 2016.

<sup>3</sup> Ibid.

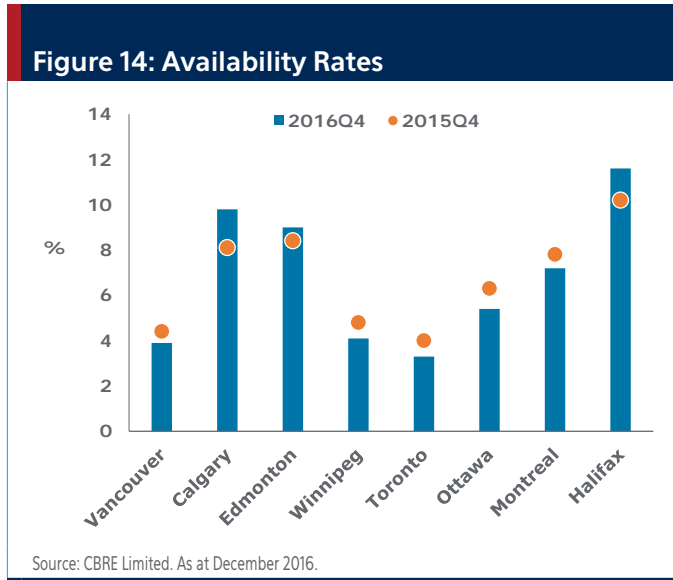
<sup>4</sup> ICSC Research. As at October 2016.



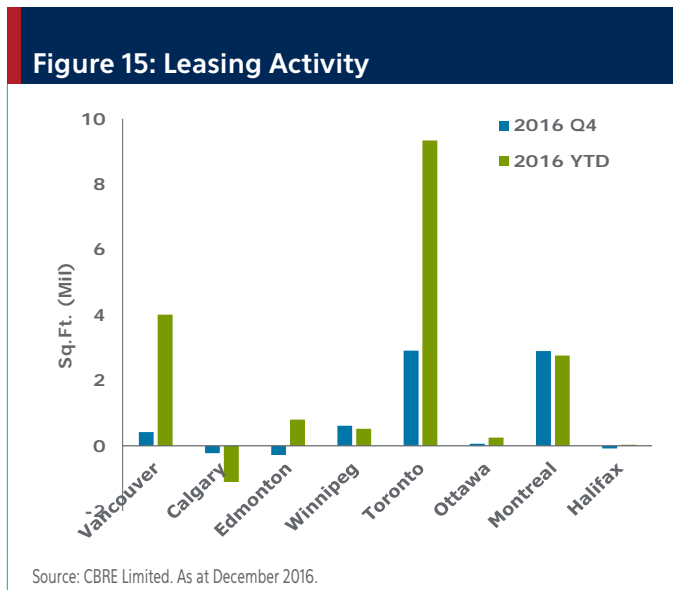
# Canadian Commercial Real Estate Market

## Industrial

The industrial market continues to be strong across most markets. National availability rates decreased 20 bps to 5.3% (See Figure 14).

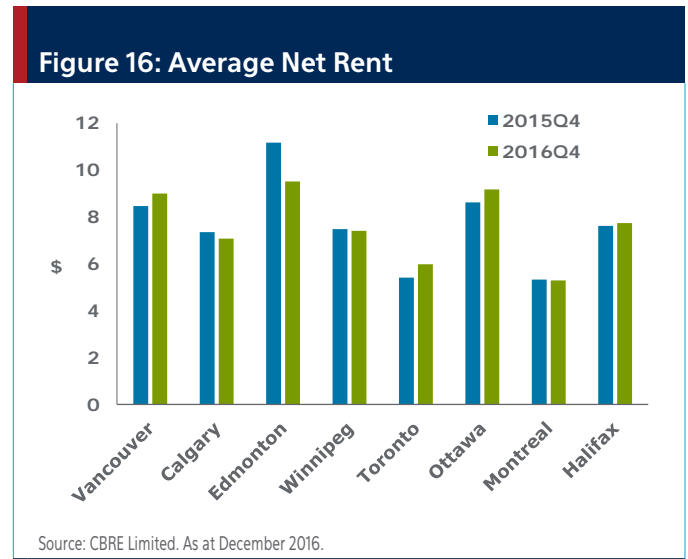


The last quarter of the year had 6.7 million square feet of positive leasing activity. Toronto, Montreal and Vancouver led all markets in the quarter for positive leasing activity. Year-to-date leasing activity was 17.9 million square feet. This is a 4.2% increase from the previous year (See Figure 15).



Tenants continue to assess their needs and balance overall costs. Generally, landlords are able to claim higher rents for quality locations near transportation hubs given that it can ultimately reduce the costs involved in logistics for tenants.

Net rental rates continue to show steady growth year-over-year. The largest percentage growth in rent has occurred in Toronto (10.5%) and Vancouver (6.4%) over a one year period.



With growth in omni-channel retailing, we are seeing demand for small bay industrial properties as tenants are looking to gain access to quality labour pools and to fill consumer requests for one- to two-day delivery. For example, in Milton, ON, which is less than one hour from downtown Toronto, we are observing an increase in demand.

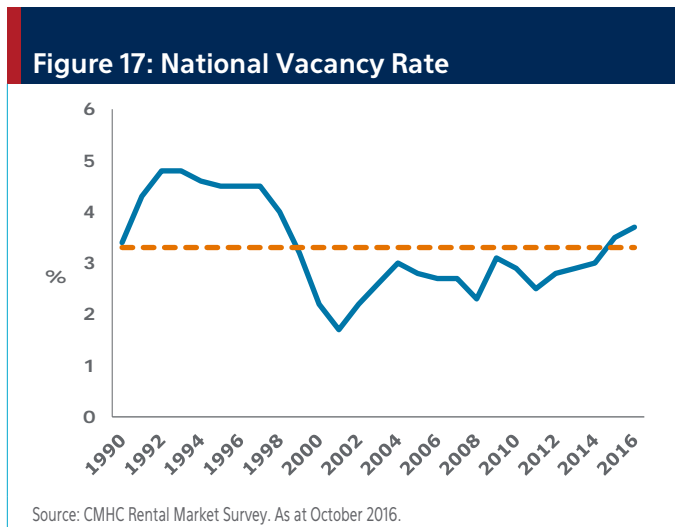
3400 Rue Raymond-Lasnier (Adidas Distribution Centre)  
Industrial, Montreal, QC



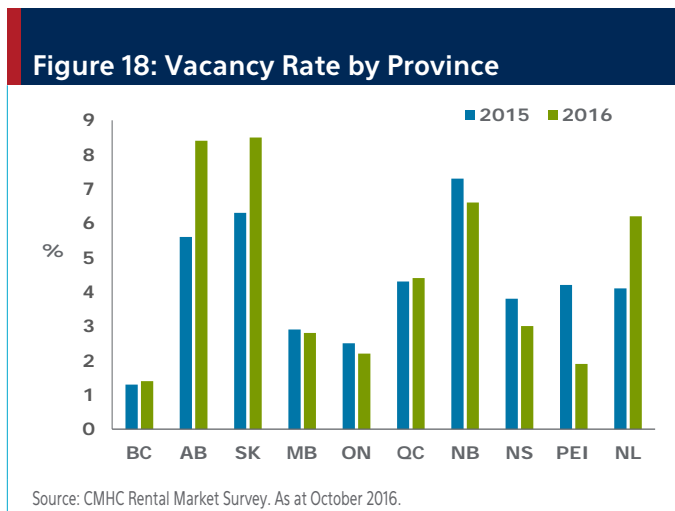
# Canadian Commercial Real Estate Market

## Multi-unit Residential

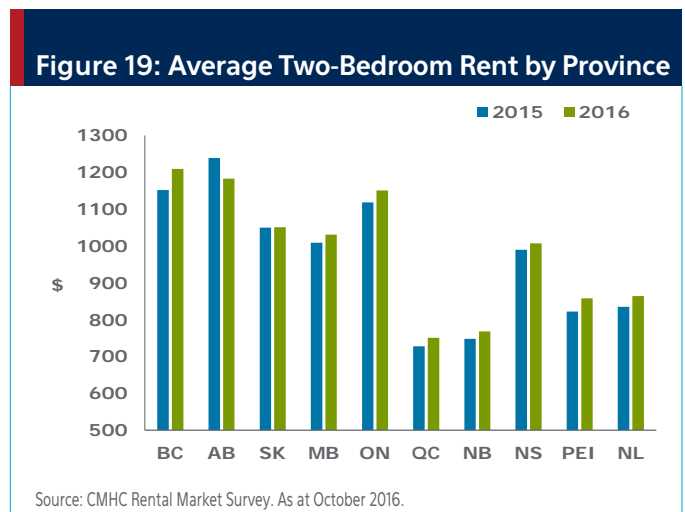
Vacancy rates increased by 20 bps to 3.7% from October 2015 to October 2016 (See Figure 17). Vacancy rates are slightly above the historical average of 3.3% (average over 27 years).



The year-over-year increase in vacancy can be largely attributable to the commodity driven provinces like Alberta, Saskatchewan and Newfoundland & Labrador. Given the elevated home prices in Vancouver and Toronto, vacancy rates continue to be stable at 1.4% and 2.2%, respectively (See Figure 18).

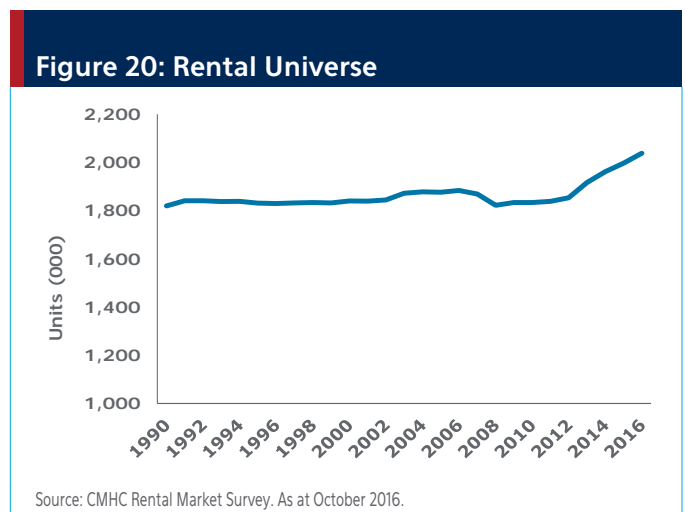


Nationally, average rents for a two-bedroom unit have increased from \$942 in October 2015 to \$965 in October 2016 (See Figure 19).



The Ontario government announced the allowable rent increase guideline at 1.5% for 2017; this is 50 bps below 2016. Conversely, British Columbia announced an allowable rent increase guideline of 3.7%; this represents a 60 bps increase from 2016.

The national rental universe increased by approximately 2% year-over-year and now stands at slightly more than two million units. Supply in Calgary and Edmonton increased by 3.7% and 4.3%, which has contributed to the increase in vacancy.<sup>5</sup> Given the current fundamentals in Alberta, we believe that there are some opportunities to acquire quality purpose-built rental units with under market rents at attractive pricing.



Overall fundamentals remain stable for this property type. Outside of Alberta, we expect steady growth in rental income over the coming year.

<sup>5</sup> TD Securities Inc. As at Nov 28, 2016.

Social Circle Solar Farm  
Georgia, USA

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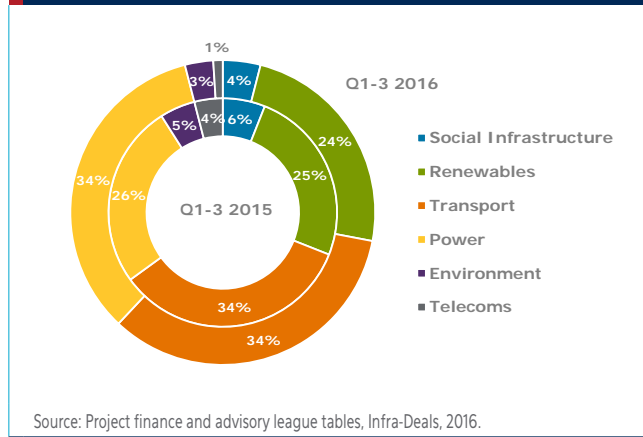
produces enough clean power for 10,000 electric vehicles to be driven 20,000 miles per year.\*

\* Factoid used with permission from Silicon Ranch Corp.

# Global Infrastructure Market

A total of 943 transactions closed globally, as of Q3-2016, worth US\$268 billion. For the first three quarters of 2016, the power and transportation sectors each accounted for 34% of all transactions, followed by renewables at 24%. Of the 137 renewable transactions that were closed in the third quarter, solar and wind represented a total of 86% of the deal flow.<sup>6</sup>

**Figure 21: Global Sector Breakdown by Value**



## North America

Following Donald Trump’s victory in the U.S. election, major industry players have formed a positive outlook for the U.S. infrastructure sector. At the forefront of President-elect Trump’s plans is a promise to spend US\$1 trillion on infrastructure over a 10-year period, along with a further US\$3 billion allocated to water and environmental infrastructure projects. In addition, Trump is creating a road map for an American Energy and Infrastructure Act to promote public-private partnerships and private investments in public infrastructure.<sup>7,8</sup>

Attracting private investment to the infrastructure sector is also a priority for the Canadian government. The Canadian Finance Minister’s Advisory Council on Economic Growth is proposing the privatization of 18 Canadian ports valued at more than C\$400 billion, in addition to investments in new projects such as domestic airports, toll highways and bridges, high-speed rail, national broadband infrastructure, and power transmission.<sup>9,10</sup>

<sup>6</sup> Project finance and advisory league tables, Infra-Deals, 2016  
<sup>7</sup> Industry sees P3 Opportunities in Trump Presidency, Infra-Americas, 2016.  
<sup>8</sup> Trump Names New Transportation Secretary, Infra-Americas, 2016.  
<sup>9</sup> Ottawa Enlists Morgan Stanley to review ownership options for 18 Canadian ports, The Globe and Mail, 2016.  
<sup>10</sup> Canada planning to privatize eight airports, Infra-news, 2016.  
<sup>11</sup> Spain reveals details of 3GW RenewableS Auction, Infra-News, 2016.  
<sup>12</sup> IWEA Welcomes REFIT II Extension as Critical Step to 2020 EU Targets, Irish Wind Energy Association, 2016.  
<sup>13</sup> Energy Update: Ireland’s REFIT Scheme Extended, Lexology, 2016.

**Figure 22: Port Authorities Across Canada**



## Europe

Opportunities in the European infrastructure market typically vary depending on sector and geography. Although some countries have pulled back their support schemes, activity remained high in the renewable sector as big-ticket investments in offshore wind were abundant in the U.K., Germany, Belgium and the Netherlands. Investors also remain confident about onshore wind and solar progress in France and the Nordics, and are buoyed by Spain’s announcement of a three gigawatt renewable energy auction in 1H-2017.<sup>11</sup>

In Ireland, the government has extended the connection deadline for its Renewable Energy Feed-In Tariff II support scheme in an effort to achieve its 40% renewable electricity consumption target by 2020.<sup>12</sup> This scheme will support the development of up to 4,000 megawatts (“MW”) of electricity generating capacity from wind, hydro and biomass relative to the 2,500 MW currently installed.<sup>13</sup>

Ballycadden Wind Farm  
County Wexford, Ireland



# Conclusion

The commercial mortgage market has a healthy level of activity. We anticipate lenders allocating more capital towards the commercial mortgage market in 2017.

The Canadian real estate market continues to experience investment activity from domestic and foreign investors; foreign investors view Canada as a safe haven with a stable political and economic environment. We expect to see high interest for core properties in the major markets of Toronto and Vancouver and to a lesser extent in Montreal.

As capital continues to flow into private unlisted infrastructure funds at record pace, the risk of return compression and an overheated market are real as investors search for deal flow. While some infrastructure subsectors have seen a slowdown in certain markets, vast opportunities remain with perhaps the most promising trend in 2017 being the growing case for infrastructure investment as a key growth driver, particularly in the U.S. where investors hold an optimistic view following the election. The sector is also facing a shift that will bring significant brownfield opportunities to market as several closed-end infrastructure funds reach maturity and begin asset divestment.<sup>14</sup>

<sup>14</sup> News Analysis: Optimism Persists despite Flat M&A Deal Volume, Infra-Americas, 2017.

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