Canadian Commercial Real Estate: Theory, Practice, Strategy

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About the Publisher

REALPAC (The Real Property Association of Canada) is Canada's premier association for real property investment leaders. REALPAC's mission is to bring those leaders together to influence public policy, educate government and the public, and to ensure stable and beneficial real estate capital and property markets in Canada.

REALPAC members currently own in excess of $250 billion in real estate assets located in the major centres across Canada, the United States (U.S.) and elsewhere in the world, and include real estate investment trusts, publicly traded real estate companies, large private companies, banks, brokerages, crown corporations, investment dealers, life insurance companies, pension funds and real estate fund managers.

About the Author

S. Michael Brooks is the Chief Executive Officer of REALPAC. He is a commercial real estate lawyer who is currently counsel to, and a former partner in and real estate practise group leader for, the Aird & Berlis LLP law firm in Toronto. Michael is an Adjunct Professor at the Ted Rogers School of Management, Ryerson University, Toronto where he teaches the capstone undergraduate course in real estate, and real estate law. Michael holds a Ph.D. and Bachelor of Environmental Studies from the University of Waterloo, School of Urban and Regional Planning, an MBA from the Schulich School of Business, York University, an LL.M from Osgoode Hall Law School and an LL.B from the University of Western Ontario. Michael is a LEED Accredited Professional (LEED AP), a Fellow of the Royal Institution of Chartered Surveyors (FRICS) and also holds the Institute of Corporate Directors ICD.D corporate director's designation. Michael has been counselling developers, investors, contractors, lenders and tenants and various service providers for over 35 years, and teaching real estate at the MBA level for over 15 years.

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S. Michael Brooks

July 1st, 2016

For Educational Purposes

The material presented in this publication is believed to be correct as of July 1st, 2016, and reflects the views and opinions of S. Michael Brooks (the author) with respect to those parts of the book of which he is the sole author, and any identified contributors in respect of their parts only, and not REALPAC or any other contributor, in any event.

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Chapter 1

Canadian Commercial Real Estate: Investment Context

1.1 Learning Objectives

This book is intended as an introduction to the theory, practice and strategy of commercial real estate in Canada. After studying this textbook, readers should have a comprehensive and relatively sophisticated understanding of the Canadian commercial real estate market.

To the best of the author's knowledge, as of the date of first publication of this textbook, there is no comprehensive Canadian textbook on Canadian commercial real estate, whereas there are a multitude of investment and real estate finance textbooks available in the U.S. and Europe. We hope we are filling a need. There is, of course, much in real estate finance and economics that is universal, such as the mathematics; however, many legal structures, institutions, and practices are unique to Canada.

Part of the motivation to write a textbook on Canadian commercial real estate comes from the fact that we have not really had one before. The author, and many of his colleagues who teach real estate to undergraduate and graduate students across Canada, usually use finance and investment real estate textbooks from the U.S. Indeed, with the U.S. institutional grade market size apparently almost 40 times bigger than Canada's, one would expect the supply of U.S. real estate textbooks of all kinds to be much deeper. One of the reasons for that may be that there are so many more Masters programs in real estate, or MBA programs with specializations in real estate in the U.S. Indeed, as this book goes to press, there are few Masters of Science in Real Estate or Masters of Real Estate programs in Canada [1]. We have a few Master of Business Administration programs with real estate specializations in Canada, notably those at the Schulich School of Business at York University,[2] the real estate specialization within the Ted Rogers School of Management program at Ryerson University,[3] the new Masters program at the University of Calgary, and the Rotman School of Management at the University of Toronto.

Another part of the motivation to write a textbook on Canadian commercial real estate comes from the fact that some of this textbook originates from the author's teaching notes (i.e., a core part of many of the chapters had already been written). Surprisingly, it had been one of the most popular (free) downloads from REALPAC's website for years – disorganized and incomplete as it was.

As a result, the genesis of this textbook comes in part from availability of supply (some of it already existed), in part from perceived demand (the many downloads of the prior version), in part from altruism – a country the size of Canada with our mature market ought to have its own textbook – and in part from blind faith: if this textbook is produced, someone will find it useful. Build it and they will come.

The target audience for this book includes undergraduate and graduate students in a university or college real estate program, young practitioners entering the real estate industry and more experienced practitioners interested in a broader exposure to the fundamentals. It will be useful for beginner investors as well as for the staff of small-to-large commercial real estate organizations and service providers.

1.1.1 Structure of the Book

The title of this textbook, *Canadian Commercial Real Estate: Theory, Practice, Strategy*, is intended to precisely reflect its content. The book falls into two parts:

1. Theory: mostly in Chapters 2 to 7
2. Practice and strategy: mostly in Chapters 8 to 12.

[1] The University of British Columbia has a Masters in Urban Land Economics, and the Schulich School of Business at York University in June 2016 announced a new Masters in Real Estate and Infrastructure starting in 2017.

[2] The author taught Structuring Real Estate Transactions in this program from approximately 1996 to 2001.

[3] The author taught Issues in Commercial and Retail Development at the Ted Rogers School of Management, Ryerson University, 2007-2014.

1.1.1.1 Part one

The first part of the book (Chapters 2 to 7) deals with the fundamental elements of real estate. In these chapters, students gain a basic understanding of supply and demand and economic fundamentals, property rights and registration systems, planning, zoning and land use regulation, sustainability, fundamentals of real estate finance, and valuation. The only substantive areas missing from this first part are chapters on real estate taxation and real estate capital markets. These may be featured in the next edition. A student with a good understanding of Chapters 2 to 7 will have the foundation to consider the typical commercial real estate transactions represented in Chapters 8 to 11. In some ways, the elements contained in Chapters 2 to 7 can be thought of as comprising the theory of real estate. For example, economic theory applies every day in a market such as real estate. Equally, a broad understanding of the theory behind property rights and planning, the goals and philosophy of the sustainability movement, and the basic mathematical theories of real estate finance and valuation should equip the student with enough theory to navigate Canadian commercial real estate markets and, indeed, any commercial market in the world after acquiring the necessary local knowledge.

1.1.1.2 Part two

Chapters 8 to 11 deal with applying the fundamentals to buying, selling, leasing, mortgaging, developing and constructing real estate. These are the main transactional elements of commercial real estate and can be understood by applying the theoretical knowledge gained in Chapters 2 to 7 plus some knowledge of practice and strategy used in the Canadian commercial real estate marketplace. These chapters are organized to explain the main components of these transactions and the strategic considerations that go into negotiations within each transactional area. The perspectives provided by the guest authors of some of the chapters will illustrate the day-to-day job functions of real practitioners.

Chapter 12: Portfolio and Asset Management, deals with the assets held in a commercial real estate portfolio. Asset management can also be considered transactional since it involves the day-to-day decisions about what assets to buy, hold, or sell, and how to manage those assets on a daily basis to achieve defined objectives. The portfolio theory elements of Chapter 12 could also be considered as further support for the theoretical underpinnings of the whole textbook. There is considerable management science available to inform asset management and property management as well.

1.2 Defining Commercial Real Estate

Real estate is land and improvements constructed on land.

Commercial real estate is:

1. real estate intended to be income producing
2. the commercial activity of development for the sale of the end product, including activities such as residential home building for eventual sale, or the construction of industrial, retail, office, hotel, housing or residential condominiums for sale.

This text is intended to cover neither corporate owned and occupied real estate nor residential real estate once constructed and sold by the developer, although several sections will be useful for these situations as well.

Income producing real estate can come in many forms. Indeed, almost any type of real estate can be rented if someone else wants to use it but does not want to own it. The typical asset classes of income producing real estate are:

- offices
- retail shopping outlets
- industrial properties
- apartment buildings
- hotels
- seniors housing complexes.

Most of the illustrations in this textbook deal with the core income-producing assets of office, industrial, retail and apartments.

Like most industries, real estate has its own terminology. A glossary has been included in this book to help the reader navigate non-traditional terms. The glossary includes a description of typical real estate asset classes. We have also defined terms and acronyms upon first use.

1.3 Real Estate Markets

1.3.1 Global Real Estate Market

Estimating the size of the global market in commercial real estate is a challenge. Chicago-based LaSalle Investment Management has estimated the size of the global investable real estate marketplace at US$49.6 trillion dollars, as of Q3 2014.[4] The segment owned by institutional public and private investors was estimated at US$9.2 trillion dollars, and the publicly traded portion of that is estimated at US$3.2 trillion dollars.[5] Prudential Real Estate Investors (PREI) in its 2012 report estimated the size of the global institutional grade commercial real estate market at US$26.6 trillion dollars.[6] That report allocated $9.4 trillion to Europe, $7.5

[4] Lasalle Investment Management: Research and Strategy: Special Real Estate Issue 2015, Analysis as of Q3, 2014. “Total Investable Real Estate” means total commercial (office, retail, industrial, niche) and rented residential buildings, but excludes owner-occupied residential homes.

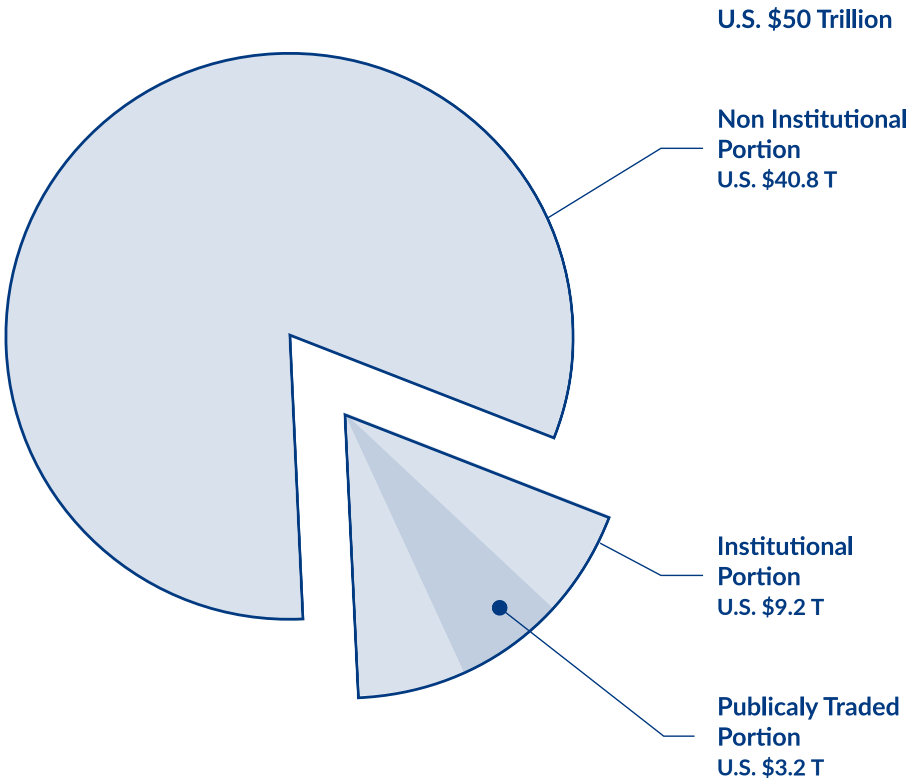
[5] Ibid., Lasalle Investment Management.

[6] “A Bird’s Eye View of Global Real Estate Markets: 2012 Update,” February 2012, Prudential Real Estate Investors, Parsippany, New Jersey. PREI is the global real estate investment arm of Prudential Financial Inc. of Newark, New Jersey.

trillion to Canada and the U.S., and $7.2 trillion to the Asia Pacific region, with Latin America having $1.8 trillion and the Gulf states $677 billion. In that report, the U.S. had $6.75 trillion of the $7.5 trillion North American total, and Canada $784 billion.

Figure 1.1:

Estimated Size of Global Real Estate Investible Market[4]



REALPAC[7] has analyzed the methodologies of assessing the size of investable markets by country, and found two main approaches: a top-down and a bottom-up approach. The top-down approach, which LaSalle and others seem generally to use, applies a formula to a country's gross domestic product to estimate the size of the institutional grade real estate investment market, with adjustments for the maturity of each market. Some countries have tried to apply a bottom-up approach, which generally involves counting every commercial building and estimating value to get at a total. In some cases, city- and town-level estimates are used. This approach is tedious and may have its own subjectivities.[8]

[7] REALPAC is a trade association representing the interests of the public and institutional real estate industry in Canada. Members include representatives from the real estate industry and REITs as well as from banks, pension funds and insurance companies with real estate assets in excess of $100 million.

[8] "Estimations of the Size of Investible Real Estate Markets: Comparative Literature Review", REALPAC, Toronto, Canada, September 2014.

The FTSE/EPRA/NAREIT Global Index Series [9] of publicly traded real estate securities contains just over US$2 trillion dollars [10] in real estate securities traded on various stock exchanges around the world as at Q4, 2014. If we assume the PREI global total (US$26.6 trillion) is all investable real estate, then the public markets were less than 8% of that in 2014. The rest was in the hands of private investors or funds. This is a big market. There is also much more that can be securitized into public markets.

1.3.2 Canadian Commercial Real Estate Market

Although Canada is a small nation in economic terms relative to the U.S., Europe and Asia, it has a sophisticated and mature real estate market. By mature we mean that the dominant players in the Canadian commercial real estate market are not wealthy families as one might find in some developing nations, but publicly traded corporations, pension funds, life insurance companies, real estate investment trusts (REITs) and other pools of professionally managed capital. To be sure, there are still many wealthy individuals and families invested deeply in real estate throughout Canada, but many have also sold their assets to a public entity, or taken their company public so as to allow further growth through access to public capital markets.

Data on the size of the commercial real estate market (as opposed to the institutional grade market) in Canada, and therefore Canada as a percentage of the global commercial real estate market, sourced from within Canada, is annoyingly difficult to come by without using a top-down approach.[11] Statistics Canada does not keep nor seek out particular data on the size or value of the commercial real estate market generally. The Canada Mortgage and Housing Corporation (CMHC) has reasonably good data on the apartment sector only. Aggregating broker market-area reports from major urban centers would be a start, but might not cover enough of the Canadian market to be useful. However, larger institutional investors tend to focus on larger markets such as the six or eight largest cities in Canada; others may focus regionally or have a suburban strategy. Knowing the size of the market based on reliable data would enable investors to better understand market share and more precisely manage over-investment and under-investment in a given market.

Commercial real estate is a large part of the Canadian economy. REALPAC commissioned a report in 2012 that conservatively suggested the Canadian commercial real estate sector produces:

- over $60 billion in annual economic activity
- approximately 340,000 jobs
- $7.2 billion in personal and corporate income tax revenue annually
- $18.1 billion in earned income annually.

[9] The FTSE/ESPRA/NAREIT Index Series measures general worldwide trends in the equities of companies owning, disposing of and developing income producing real estate.

[10] www.epra.org (accessed December 25, 2014).

[11] The “top down” approach as discussed in footnote 8 above.

Construction taken together with real estate is likely one of the two or three biggest industries in Canada.

1.4 Top 10 Attributes of Canadian Commercial Real Estate

The purpose of studying real estate management as a science is to understand the business of commercial real estate and to train people to acquire, develop, sell, finance, lease and manage commercial real estate for both income and, hopefully, capital appreciation through both up and down cycles. Society benefits when a country's real estate is well developed and well managed because it supports all economic activity. Canada is no exception.

The top 10 attributes of Canadian commercial real estate are:

1. relatively small market
2. investability
3. physicality
4. adaptability
5. collateral
6. mortgages
7. profitability
8. risk of loss
9. strong banking system
10. people and reputations.

1.4.1 Relatively Small Market

The Canadian commercial real estate market is large to Canadians but small in relation to the global market. With US$784 billion of institutional grade real estate (the PREI number referenced above), there is much to choose from in Canada. On the other hand, Apple Inc. had a market capitalization of US$735 billion as at June 2015. If Canada's institutional grade real estate market is 1/10 the size of the U.S. institutional-grade real estate market,[12] Canada's market size should be US$2.6 trillion. As it is, Canada is not even 1/20 of the U.S. institutional grade real estate market; it is actually closer to 1/40 if we agree with the PREI numbers. Canada is not a big country for investment-grade real estate according to those PREI numbers. This suggests Canadians would benefit from making investments in real estate outside their borders.

1.4.2 Investability

The Canadian real estate market may be small by world standards but offers ample opportunity for investment. Those with capital seeking a return on investment can purchase income producing real estate and obtain a yield and perhaps capital

[12] The 1/10 fraction represents the relative populations of the two countries.

appreciation as time goes by. Traditionally, well-maintained real estate is a good inflation hedge.[13] In most cases, capital appreciation can be enhanced by appropriate additional capital investment, active and intelligent management, careful leasing and proper ongoing maintenance. On the other hand, capital appreciation is not guaranteed. Students must understand that most real estate markets are cyclical, reflecting the ups and downs of the economy at large or, in some situations, unique market ups and downs based on local overbuilding, poor management, regional economic events, a significant immediate drop in local demand, and the like. Prudent investors diversify their investments to avoid or minimize the effect of down cycles; declines in value in one area or asset class can be offset by stability in the other areas or asset classes and leave enough equity or cash on hand to enable the investor to ride out the down cycles.

1.4.3 Physicality

The physicality of commercial real estate is very evident in Canada with its diverse geography, climate, businesses and industries, cities and countryside. You can see real estate. You can touch real estate. You can drive by real estate. You can show real estate to your family. You can show real estate to your banker. It has been estimated that 70% of the world's wealth is tied up in real estate.[14] Real estate cannot be made obsolete by a better invention (although it may be made less valuable).

1.4.4 Adaptability

Canadian commercial real estate has proven to be very adaptable as industry and commerce have changed and the population increased. Buildings are built and rebuilt and densities have increased in urban centres. The layout or appearance of commercial real estate changes as properties are repurposed and the quality of property can be upgraded as new technologies enter the marketplace.[15] On the other hand, buildings can depreciate to the extent they become functionally obsolete, accumulate a large amount of deferred maintenance or fall into disrepair. Property can become locationally obsolete for an intended use. Adaptability goes both ways: owners can add value or subtract value.

[13] Real estate generally performs as an effective inflation hedge if markets are in balance, according to the work of Charles H. Wurtzebach, Glen R. Mueller, and Donna Machi, "The Impact of Inflation and Vacancy of Real Estate Return", p. 153, the *Journal of Real Estate Research*, Summer 1991. More recently, "Commercial Real Estate has handily beaten inflation except during periods of severe supply gluts brought about by too much construction or a collapse in demand": Martha S. Peyton, "Is Commercial Real Estate an Inflation Hedge?", Real Estate Issues, Volume 36, No. 3, 2011, at p. 37.

[14] http://www.unpri.org/whatsnew/unep-fi-launches-corporate-real-estate-sustainability-management-framework-for-the-financial-industry/ (accessed June 22, 2015).

[15] Subject to local planning regulation.

1.4.5 Collateral

Canadian commercial real estate is good security for a loan. Many sources of domestic and international financing exist for good real estate. Public equity for real estate is sourced in Canada through stock markets, primarily the Toronto Stock Exchange. Private equity might be sourced through family and friends or small syndications or from professional investors.[16] Public debt may be sourced through bonds and commercial mortgage-backed securities that may trade on a public stock exchange. Private debt such as a mortgage may also be used. Typically, a purchaser may be able to obtain first or second mortgage financing from a bank, credit union, private lender or a life insurance company. A mortgage broker can often assist in finding the best mortgage "fit."

1.4.6 Mortgages

A strong mortgage market is essential for financing commercial real estate and the Canadian market is huge. As of May 2014, the disclosed institutional commercial mortgage market in Canada was estimated at approximately $145 billion. In other words, this was the amount of loans outstanding by institutional lenders secured against commercial real estate in Canada.[17] Given the size of the Canadian institutional grade real estate market (estimated by PREI above at US$784 billion in 2011), less than 20%[18] of institutional grade commercial property in Canada was funded by institutional grade lenders in 2013.

1.4.7 Profitability

Canada is an excellent country in which to invest in real estate. The country is politically stable and federal, provincial and municipal laws encourage growth while systematically guiding rational development of residential areas, commerce and industry. As with all investments, there is both opportunity and risk in commercial real estate. There is opportunity because of the ability to add value through physical improvements to land. There is the ability to add value through regulatory approvals to land (such as by increasing permitted height and/or density, or changing permitted uses to a use more highly valued in the marketplace). There are opportunities to benefit from increasing rents to the extent there is scarcity of supply (or excess demand) in a given market for that particular use or location. There is the ability to achieve capital gains if inflation makes substitute properties more expensive or if the market demand for the rent generated by the building increases the value of the building.

[16] Crowdfunding is limited in many ways (as at September 2015). REALPAC released a preliminary analysis in March 2016.

[17] Cynthia Holmes and REALPAC, *2014 Canadian Institutional Commercial Market Report* (Toronto: REALPAC, 2014).

[18] It would be unclear how much private debt, not counted in the REALPAC study, would add to the institutional grade debt.

1.4.8 Risk of Loss

Risk of loss is a normal business risk. In Canada, the last major real estate recession occurred in the 1990-1994 period, with shorter economic shocks in 2000-2002 and 2007-2008. In the 1990-1994 period, the combination of a broad market recession, massive overbuilding in office real estate in many Canadian markets (especially Toronto), highly leveraged borrowers and undisciplined market activity, as well as a rapid increase in interest rates, led to a partial collapse of commercial real estate as an asset class in many cities. In that recession, many landowners lost their equity and indeed were forced to forfeit their properties to their lender, many of whom also lost money. Indeed, many Canadian trust companies were wiped out by real estate losses in the 1990-1994 period.

1.4.9 Strong Banking System

In 2014, the World Economic Forum voted Canada's banking system the best in the world for the seventh year in a row.[19] Strong banks help stabilize real estate. Many younger Canadians employed in today's commercial real estate market have never lived through a major recession that drastically impacts commercial real estate. The global financial crisis of 2007-2008 barely impacted Canadian commercial real estate, except for a short period of time in 2008 when capital markets froze. Otherwise Canada experienced no material diminution of lending activity overall, no fire sales of assets, and no spikes in mortgage defaults similar to the defaults that occurred in the U.S. during 2007-2009. The Canadian real estate market indeed benefits from the most stable and responsible banking system in the world.

1.4.10 People and Reputations

Although commercial real estate is made up of land and buildings, it is really a business about people, for people and by people: giving people a place to live; giving people a place to work and shop; giving people places to go; giving places life – places that are attractive to people draw renters and generate higher rents; those that do not, generally do not rent well, or rent at a lower price point.

Those needs change over time, reflecting changing societal priorities, technological advancement, and economics. Low-ceiling-height industrial was made obsolete by lift trucks that could lift pallets of goods higher. Newer industrial facilities now have ceiling heights approaching 40 feet. Strip retail and main-street[20] retail were overtaken (at least for a time) by modern enclosed (and air conditioned) indoor shopping malls. Older brick office and other buildings with fixed interior concrete walls were made obsolete by steel and concrete office towers with clear longer spans between the elevator and the external windows, and movable partitions. Elevators and air conditioning made obsolete those buildings that did not have them.

[19] http://www.fin.gc.ca/n14/14-114-eng.asp (accessed April 14, 2016).

[20] In Europe, main street retail is often called "high street" retail.