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Overview

Canada's economy, especially in the province of Ontario, has been one of the best performers among industrialised countries over the last few years. Canadian economic growth in 2017 was the fastest among G7 countries and is projected to be second fastest (to the USA) in 2018. Real estate is the largest sector, representing 13% of Gross Domestic Product (GDP) – 20% including construction. The province of Ontario (where Toronto is located) is Canada's primary economic engine, contributing 39% of GDP. While consumer spending, according to the OECD, leads the growth, business investment is also surging. All this makes the country an attractive venue for real estate investment and development.

A constant environment adds to the allure, especially for foreign investors. Quite apart from the famously stable political setting, the Canadian real estate market remained relatively steady during and after the Great Recession of 2008-9, in stark contrast to the dramatic correction in asset prices in the USA, UK and Europe. The upshot is that Canada offers foreign investors the advantages inherent in a North American geographical real estate portfolio allocation without exposure to the volatility that characterises the USA in periods of downturn.

What follows is a review of individual real estate sectors.

Residential

Introduction

Residential real estate prices in major markets like Toronto and Vancouver have been increasing at a rapid pace for several years now. The Canadian Real Estate Association reports that home prices in Toronto rose by a staggering 145% in the past decade. The inflation of housing costs has been particularly drastic over the last three years, especially in Toronto, where average prices have increased more than 40%. Home prices in Canada as a whole increased 13% year-over-year in the fourth quarter of 2016 alone – the highest year-over-year national home price increase recorded in more than a decade.

Low interest rates, supply constraints and immigration have all driven this market. Immigration into Canada sits at some 300,000 people annually, at least 100,000 of whom settle in the Greater Toronto Area (GTA).

Supply constraints exist as well, and are most acute in the hottest markets. Adjacent water and mountains limit the territorial growth of Vancouver's downtown area. In Ontario, the constraints are politically induced. In 2005, the government introduced "greenbelt" legislation designating 1.8 million acres of land in in the Greater Golden Horseshoe Region (GGHR), which embraces the GTA and Niagara, as non-developable. The housing industry blames the consequent reduction in low rise housing starts beginning in 2007 and each and every year thereafter on a shortage of buildable land caused by the greenbelt legislation.

Eventually, price increases became so frothy that provincial and federal governments felt compelled to enact legislation aimed at preventing a bubble. The steps taken tempered the markets: 2018 is now expected to produce a cooler, but still rising, housing environment. The low rise market has slowed most, even as condominium sales continue to be strong. Still, given continued population growth fuelled by immigration, the continued strength of the residential real estate sector in the GTA seems assured for the foreseeable future.

Government Steps

In the face of strong domestic economic performance, the Bank of Canada has recently raised the overnight rate 50 basis points from its historically low 0.5% in 2017. Further increases may come in tandem with increases in the U.S. Federal Reserve rate.

For its part, the federal government introduced a new mortgage stress test on 1 January 2018. The Office of the Superintendent of Financial Institutions (OSFI), which oversees federally-regulated financial institutions (FRFI), has directed them to contemplate future as well as current conditions in their consideration of qualifying rates. These lenders must now make appropriate judgements and, at a minimum, ensure that the qualifying rate for all uninsured mortgages equals the greater of the contractual mortgage rate plus 2%, or the five-year benchmark rate published by the Bank of Canada. OSFI has also tightened other requirements, such as loan-to-value ratios, and clarified that "borrowers" are not limited to individuals, but include any legal person.

In Ontario and British Columbia, the provincial governments have focused new speculation taxes on foreign buyers, who were seen as contributors to a potential bubble. Among other measures, Ontario introduced its non-resident speculation tax ("NRST") in April 2017. The

NRST attempted to address the unsustainable demand in key regions by taxing foreign speculation while leaving the market open to newcomers to Canada.

The NRST imposes a 15% tax on any transfer of residential property in the GGHR that contains six or less single-family residences to a foreign entity, which includes corporations and individuals. In its first seven months, the NRST generated CAD132.6 million in revenue from over 1,000 transactions. During the same period, foreign buyers' share of transactions dropped from 7.2% to 3.8% in Toronto and 4.7% to 1.9% across the GGHR. Home resales declined by 13.3% and average sale prices decreased by 2%.

While supporters of the NRST laud these early results, they should be interpreted cautiously. After British Columbia passed similar legislation in June 2016, the British Columbia Real Estate Association reported that home sales in the impacted area fell by 19% in the first few months. By mid-2017, however, sales had returned to levels anticipated had the tax not been in place.

Clearly, more time is required to properly assess the NRST's impact. While early results are promising for those wishing to keep home prices in check, it may be that the NRST will engender greater gaps in longer-term affordability. Early trends may also represent no more than a combination of reactive market psychology and a cooling housing sector.

If, on the other hand, additional data demonstrates that the NRST has achieved its goals, it is likely that the tax will expand beyond the GGHR. In the interim, the NRST has at least provided significant tax revenue that contributed to a balanced 2017 budget and softened public fears over rising house prices.

One other, earlier government step must be mentioned as well: at the time of enacting the greenbelt legislation, the Ontario government recognised that it would affect supply. The powers-that-be also recognised that immigration would increase population in the GTA. Consequently, in 2006, the government introduced a Places to Grow initiative. Among other things, the initiative directed municipalities to intensify their population density.

As Maclean's magazine noted recently, cities facing high housing demand can respond by growing in two ways – outward or upward. Having restricted the outward option, the upward option has been the favoured one, particularly in Toronto, which is witnessing an explosion in high-rise condominiums. Vancouver has also seen an enormous increase in density over the last decade. Still, Toronto and Vancouver continue to feature low densities compared to many other major cities in the world.

Also worth noting is the recent replacement of the Ontario Municipal Board (OMB) with a new tribunal, the Local Planning Appeal Tribunal (LPAT). The government expressed this as a change designed to "giv[e] communities a stronger voice". The OMB's broad reach to overturn a municipal decision had long been unpopular with local politicians and individual property owners: among other things, because the OMB had the authority to hold hearings and hear extensive evidence in land use planning appeals, planners exercised significant power over the development process and reduced the ability of local politicians to protect constituents with NIMBY-type legislation and by-laws.

LPAT is intended to function as a true appeals body for major land use planning decisions. The tribunal will not have the power to hold de novohearings or to overturn local municipalities' decisions. Instead, LPAT's mandate is to determine whether the municipality followed provincial policies or municipal plans in arriving at its decision. If the municipality's decision did not do so, LPAT must remit the matter to the municipality, which will have 90 days to make a new decision. Only if and when the tribunal finds that the municipality's second decision still fails to comply with provincial policies, laws, or municipal plans does LPAT have the power to impose its own views. Still, an inevitable result of this new regime will be greater resort to the courts by developers seeking to overturn unduly restrictive planning restrictions imposed by municipalities.

Unfortunately, the transition from the OMB to LPAT again seems destined to constrain residential market supply. It will also not help keep prices under control. But, even as Ontario remains an attractive forum for real estate investment, the evolving legislative environment does demonstrate that the complexity of the legalities is a serious consideration for potential investors.

Consequences and Opportunities

The combination of governmental measures means that there will be some decrease in the number of real estate purchasers entering the market. This will produce a slower market, particularly in low rise housing. Despite an initial downturn, however, the longer-term impact is as yet unclear. With supply still constrained and immigration marching on, the sector as a whole remains attractive, led by a robust condominium market.

Government constraints may, however, present opportunities for non-federally regulated lenders to enter the residential mortgage business and provide mortgages no longer available from FRFIs. The interest rates that these non-traditional lenders can obtain will doubtless be higher and more attractive to lenders than what Canadian bank rates would have been in an unchanged environment.

Retail

Introduction

As PWC has noted, "Although overall retail sales performance is quite strong, during the last several years essentially all of the inflation-adjusted gains in retailer revenue have been driven by online channels, which enjoy growth rates as much as 7% higher than retail sector growth as a whole. Meanwhile, traditional retailers are faced with flat or declining sales and large, costly store networks." In Canada, the recent bankruptcies of two large, traditional retailers, Target and Sears, are cases in point.

Traditional retail, based upon the historic shopping plaza/strip mall development model, faces unprecedented challenges. Premised on the idea, "If you build it, they will come", retail outlets located at highway intersections provided easy access for consumers travelling to or from their homes or offices. The evolution of online shopping, however, has seen this concept replaced by mixed-use “mini-cities”, which permit consumers to live, work, and shop, with these activities all within walking distance of each other.

Trends

While the “mini-city” concept is still gaining traction in Canada, it has been well utilised in the USA and elsewhere: for example, “The District” – located just west of Milwaukee, Wisconsin – contains a 270,000 sq ft, fashion-oriented retail centre built within repurposed warehouses, a row of local and regional restaurants, and 1,000 apartment units (to be constructed in the next five years or so). Lake Nona, Florida, close to Orlando, boasts a 11,000-acre mixed-use development, containing 10 million sq ft of office, commercial, medical, research, residential, educational and hospitality space. Other examples include the Oculus project in New York City and Langham Place in Hong Kong, both subjects of a recent article in The Guardian.

Closer to home, the Shops at Don Mills, built in 1955, was redeveloped in 2009 as Toronto’s first open-air retail centre. Recently added are 65,000 sq ft of office space and about 2,000 residential units with three of the seven planned condominium towers completed to date. The Vaughan Metropolitan Centre, north of Toronto, which will boast 1.5 million sq ft of office space, 750,000 sq ft of retail space, and 12,000 residential units serving as homes to 25,000 people when fully developed, foreshadows the continued emergence of office, retail and residential space having direct access to the City of Toronto’s subway system.

Demand to be part of these communities comes not only from consumers, but also from the corporations that employ them and municipalities seeking to expand their tax base. One commentator has noted that corporations “view [these communities] as a recruiting tool as they compete for young workers in search of an urban environment that offers restaurants and other amenities”. Another notes that “mall REITs see opportunities for adding density to their properties in 2018 by building in housing, office and hotels, and there are plenty of residential REITs eager to co-develop”. Indeed, Edward Sonshine, the CEO of RioCan REIT (Canada’s largest REIT), is a pioneer in recognising the synergy involved in constructing residential buildings on unused density attached to retail malls.

International Council of Shopping Centers (ICSC) President and CEO Tom McGee has acknowledged that ICSC members are transforming properties into live-work communities by adding housing, offices, and hotels. These communities may be developed in already densely populated areas through the renovation and expansion of existing centres or the creation of new mini-cities. Such mixed-use, it is commonly believed, “works best in urban environments that already enjoy density” and will always be more complex than developing traditional retail centres.

Opportunities

As consumer desires change and the availability of land near large city cores becomes increasingly scarce, it is likely that there will be a higher demand for these new types of communities in Canada. Continuing immigration and development in the GTA will create retail market opportunities for new ideas developed in conjunction with densification concepts – for example, along the new Eglinton Light Rapid Transit corridor in Toronto.

Office

Introduction

The Canadian office market is quite expensive right now and returns are quite low. This is in keeping with the lower volatility in this market. It is anticipated that prices will drop as interest rates continue to increase. For the time being, however, the strong demand for office real estate is offsetting the impact of the rate increases that have occurred so far. The unit prices of listed real estate companies such as Real Estate Investment Trusts (REITs) have dropped recently as interest rates have increased. Although this trend seems to be continuing, the underlying real estate has not yet declined in value.

Trends

A recent trend has seen large pension funds selling a 50% non-managing interest in some of their key office holdings (eg, Bay Adelaide, RBC Centre, in Toronto). This gives the funds the ability to further diversify outside of Canada without giving up control of Canadian assets.

Opportunity

As there appears to be more volatility in holding Canadian real estate through the capital markets (REITs) as opposed to owning bricks and mortar, foreign investors may be more interested in the latter, especially given the overall stability of the Canadian market. Indeed, foreign investors who purchase a 50% non-managing interest in a pension fund managed asset will be rewarded with low volatility both in the asset's value and the proven stability and strong management capabilities of their new business partners.

Industrial, Hotel and Other

Industrial

The industrial sector is seeing solid growth in the GTA. One broker notes that "8.8 million sq ft of new supply [were] delivered in 2017 of which 5.6 million was speculative". Still, the vacancy rate has been only marginally affected. The industrial vacancy rate in Canada hit 3.9% at the end of 2017, the lowest since 2001, with rents up 15% in Vancouver and 7.3% in Toronto from 2016, according to Cushman & Wakefield.

While the continuing re-negotiations involving the North American Free Trade Agreement may affect this sector, it is speculative at this point to predict their ultimate impact.

Hotel

The hotel industry in Toronto is also booming. CBC recently noted that hotel investment in Canada hit record-setting levels in 2016. The year featured more than CAD4 billion in hotel transactions, with another CAD2.8 billion worth of hotel-related deals recorded as of November 2017. Downtown Toronto represents one-third of the transaction volume for all of Canada.

Other

Canada is at the forefront of legalisation of recreational marijuana, scheduled to occur later in 2018. Deloitte has recently projected the potential size of the legal, recreational retail cannabis market at CAD9 billion. There has been a “green rush” by equity investors into medical marijuana companies, with more than CAD466 million raised in Canadian capital markets in 2016 and, overall, billions of dollars invested over the last several years into fledgling companies, many of which still haven’t a dot of black on their balance sheets.

The industry will likely have a significant impact on the real estate market with increasing focus on the acquisition, disposition and leasing of real estate used to grow, process, distribute and retail cannabis. According to brokerage Jones Lang LaSalle Canada, the country’s eight biggest marijuana companies will require more than 8 million sq ft of space for growing marijuana by 2020, up more than fivefold from current levels.

While many people thought that solar development would wind down once the Ontario Feed-in Tariff programme came to an end, as a result of disappearing subsidies, that is far less certain at this time. The decreased cost of producing solar power, combined with an apparent increase in the longevity of the generating equipment, has opened the door for continued development. The ever increasing development of battery and other energy storage technologies will also help support the future of solar power. Solar development requires significant land area, be it rooftop or ground mount, and significant upfront costs which must be adequately financed, but the increased profitability make it a significant trend for real estate development going forward.

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