CUSHMAN & WAKEFIELD

PERSPECTIVE

QUARTERLY REPORT ON
COMMERCIAL REAL ESTATE CAP RATES
IN MAJOR CANADIAN MARKETS

Q1 2018

Are Cap Rates Reaching a Tipping Point?

> *Overall demand for commercial real estate in Canada remains ferocious, fueled by sound real estate fundamentals*

EXECUTIVE SUMMARY

Cooling Signs, But the Party Isn't Over

With the Bank of Canada's overnight lending rate up 75 basis points since last summer, rising to 1.25%, and further bumps expected through 2018, subtle changes are occurring in specific markets and asset classes. These glimpses offer the first evidence that cap rate compression may be reaching a tipping point as we head into the ninth year of a record-long growth cycle.

Make no mistake though; despite rising interest rates and other dampening factors, the vast majority of individual markets and asset classes saw cap rate stability and in some cases, further compression. Overall demand for commercial real estate in Canada remains ferocious, fueled by sound real estate fundamentals, transformative change, and an abundance of capital seeking long-term investment opportunities.

However, with five-year BOC bond rates up by between 100 and 110 basis points, we are starting to see key asset classes in Toronto such as street-front retail product under $30 million and low-rise multi-residential housing experience buyer resistance to cap rates that were achievable one year ago. These early indications of a growing gap between seller and buyer expectations suggest we could be approaching a tipping point.

Still, the investment party isn't over yet. Strong fundamentals, upward pressure on lease rates, record-high occupancy rates, and a competitive Canadian dollar are some of the factors that will continue to push this historic cycle along, even though it is clear that compression cannot continue indefinitely.

HOTEL

Heated Demand Drives Suburban Cap Rates to New Lows

For investors who want to place capital in a commercial sector that has outperformed the market in recent years and offers a yield advantage, look no further than the hotel sector. Rising occupancy and room rates continue to reinforce fundamentals and drive solid returns across hotel assets. In Toronto, suburban hotel product has been a stand out, delivering a 150-200 basis point yield advantage over CBD hotel properties.

2017 marked one of the strongest hotel investment years on record, generating sales of $3.5 billion. Central Canadian markets, including Montreal, Toronto, Ottawa, London, and Kitchener Waterloo, attracted the lion's share of investor activity, capturing 65% of all national single-asset trades. This demand strength has carried into 2018 with well-capitalized private investors hot on the trail for Canadian hotel assets.

Cap rates on full-service and limited-service suburban hotels across central Canadian markets fell by 25-to-50 basis points in the first quarter. While we predict that cap rates are nearing bottom, this sector will continue to see exceptional demand as private capital continues to invest heavily in the commercial real estate sector.

CLASS B INDUSTRIAL

Strong Demand against Limited Supply Pushes Cap Rates Downward

Industrial as an asset class has become the darling of commercial real estate in recent years, marked by tremendous growth due to the evolution of e-commerce. Development activity simply cannot keep pace with the powerful demand momentum across Canada's largest markets, and the results speak for themselves. Vancouver and Toronto, the two hottest markets in the country, are seeing near record-low availability rates of 2.1% and 2.2%, respectively.

We know there are many more chapters to this incredible story. In Toronto, with an industrial inventory approaching 800 million square feet, availability is at its 35-year-low watermark. Developers are more challenged than ever before, faced with scarce land availability, record-high land prices, and rising development charges. As a result, rental rates in both Vancouver and Toronto are seeing significant upward pressure, and this is likely to continue, particularly in Toronto where asking rates have been very competitive relative to other Canadian markets.

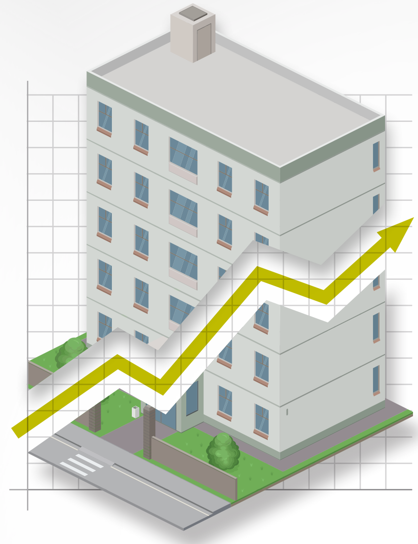
While GTA class A cap rates held stable over the first quarter, strong demand and higher yield opportunity supported fierce bidding and further compression of class B industrial product. Cap rates fell by 25 basis points, with the majority of sales landing in a range of between 5.25% and 6.25%.

STREET-FRONT RETAIL

Softer Fundamentals in GTA Widen Expectation Gap between Buyer and Seller

Street-front retail cap rates have hit historic lows in recent years, particularly in Vancouver and Toronto on hot urban streets that attract strong foot traffic and support buoyant sales. Weakening fundamentals and rising interest rates have added to the uncertainty of buyers, who are showing greater resistance to buying in at low watermark cap rates, particularly for product below $30 million in Toronto. This is the first evidence of a growing gap between buyer and seller expectations.

High-street retail real estate has been challenged in recent years by the meteoric rise of e-commerce sales. Rising vacancy rates and greater risk, including an erosion of key retail segments, such as street-front fashion locations, are putting greater scrutiny on tenants and the security of their projected cash flow. Location, segment focus, and the ability to repurpose larger space are impacting projected value, and we expect to see continued upward cap rate pressure on Toronto's street front product over the balance of 2018.



MULTI-RESIDENTIAL

GTA Low-Rise Product Sees First Cracks as Interest Rates Rise

With five-year BOC bond yields up between 100 and 110 basis points, interest rates on commercial debt are on the rise across Canadian markets. Further, the fundamentals supporting multi-residential development in Toronto have been challenged by the introduction of stringent provincial rent controls. This limits the ability of asset owners to increase rents in a market where demand is far outstripping supply, creating roadblocks to sorely needed new development.

Given these fundamentals in addition to record land prices, zoning challenges, and approval delays, prospective buyers of low-rise buildings are showing greater reluctance to meet seller expectations. Reflecting this shift in sentiment, cap rates on low-rise assets increased by 25 basis points across the GTA. We can expect continued pushback from prospective buyers as we see further interest rate increases in the quarters to come. That said, location and access to transit remain critical differentiators supporting cap rate stability.

Q1 2018 CAP RATE SURVEY REPORT

Commercial Real Estate Cap Rates Across Canadian Markets

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NEXT »

	VICTORIA			VANCOUVER			CALGARY			EDMONTON			WINNIPEG			LONDON		
	RANGE			RANGE			RANGE			RANGE			RANGE			RANGE		
DOWNTOWN OFFICE	LOW	HIGH	OUTLOOK	LOW	HIGH	OUTLOOK	LOW	HIGH	OUTLOOK	LOW	HIGH	OUTLOOK	LOW	HIGH	OUTLOOK	LOW	HIGH	OUTLOOK
AA	4.75%	5.25%	◄ ►	3.75%	4.50%	◄ ►	5.00%	5.75%	◄ ►	5.75%	6.75%	◄ ►	N/A	N/A	N/A	N/A	N/A	N/A
A	5.00%	5.50%	◄ ►	4.00%	4.75%	◄ ►	5.75%	6.50%	◄ ►	6.75%	7.50%	▲	5.50%	6.25%	◄ ►	6.50%	8.25%	◄ ►
B	5.25%	5.75%	◄ ►	4.25%	4.75%	◄ ►	6.75%	7.75%	◄ ►	7.75%	8.75%	◄ ►	6.25%	6.75%	◄ ►	8.00%	9.00%	◄ ►
SUBURBAN OFFICE																		
A	5.25%	5.75%	◄ ►	4.50%	5.25%	◄ ►	6.25%	6.75%	▲	6.25%	6.75%	▲	6.25%	6.75%	◄ ►	6.00%	8.00%	◄ ►
B	5.50%	6.00%	◄ ►	5.25%	5.75%	◄ ►	6.75%	7.75%	◄ ►	7.00%	7.75%	▲	6.75%	7.50%	◄ ►	8.00%	8.75%	◄ ►
INDUSTRIAL																		
A	5.25%	6.00%	◄ ►	4.00%	4.50%	◄ ►	5.25%	5.75%	◄ ►	5.75%	6.50%	◄ ►	6.50%	7.00%	◄ ►	6.75%	8.00%	◄ ►
B	5.75%	6.25%	◄ ►	4.50%	5.00%	◄ ►	5.75%	6.25%	◄ ►	6.50%	7.50%	◄ ►	7.00%	7.75%	◄ ►	7.50%	8.75%	▼
APARTMENT																		
High Rise	3.25%	3.75%	◄ ►	2.50%	3.00%	◄ ►	5.00%	5.50%	◄ ►	4.50%	5.00%	◄ ►	4.75%	5.75%	◄ ►	4.50%	5.75%	◄ ►
Low Rise	3.50%	4.00%	◄ ►	2.75%	3.50%	◄ ►	5.00%	5.50%	◄ ►	5.75%	6.25%	◄ ►	5.00%	5.75%	◄ ►	5.25%	6.50%	▼
HOTEL																		
Full-Service Downtown	6.00%	7.00%	◄ ►	5.00%	6.25%	◄ ►	7.00%	8.00%	◄ ►	8.00%	9.00%	◄ ►	8.00%	9.00%	▼	8.00%	8.50%	◄ ►
Full-Service Suburban	7.00%	8.00%	◄ ►	6.00%	7.50%	▼	8.25%	9.25%	◄ ►	8.50%	9.50%	◄ ►	9.00%	10.00%	◄ ►	8.00%	9.00%	▼
Limited-Service Suburban	7.50%	8.50%	◄ ►	7.00%	8.00%	◄ ►	9.00%	10.00%	◄ ►	9.00%	10.00%	◄ ►	9.50%	10.50%	◄ ►	8.50%	9.50%	▼
RETAIL																		
Street Front - Top Performer	4.75%	5.25%	◄ ►	3.25%	4.00%	◄ ►	5.25%	6.00%	◄ ►	6.00%	6.50%	◄ ►	6.00%	6.50%	▲	6.00%	7.00%	◄ ►
Regional Mall - Top Performer	5.00%	5.50%	◄ ►	4.25%	4.75%	◄ ►	5.00%	5.50%	◄ ►	5.00%	5.75%	◄ ►	5.50%	6.00%	◄ ►	5.75%	6.00%	◄ ►
Power Centre	5.00%	5.50%	◄ ►	4.75%	5.25%	▲	5.50%	6.00%	◄ ►	5.25%	6.00%	◄ ►	5.75%	6.25%	◄ ►	6.00%	6.50%	◄ ►
Community Commercial Centre	5.25%	6.00%	◄ ►	4.50%	5.25%	▲	5.00%	5.50%	◄ ►	6.50%	7.25%	◄ ►	5.75%	6.25%	◄ ►	6.50%	8.00%	◄ ►
Strip Plaza Anchored	5.00%	5.50%	◄ ►	4.25%	5.00%	▲	5.25%	5.75%	◄ ►	5.50%	6.25%	◄ ►	5.75%	6.50%	◄ ►	5.75%	6.50%	◄ ►
Strip Plaza Non-Anchored	5.25%	6.00%	◄ ►	4.50%	5.25%	▲	5.75%	6.25%	◄ ►	6.50%	7.25%	▲	6.50%	7.00%	◄ ►	5.75%	7.00%	◄ ►

LEGEND » OUTLOOK: UP: ▲ DOWN: ▼ FLAT: ◄ ►

Q1 2018 CAP RATE SURVEY REPORT

Commercial Real Estate Cap Rates Across Canadian Markets

CUSHMAN & WAKEFIELD

BACK «

	KITCHENER/ WATERLOO RANGE			TORONTO RANGE			OTTAWA RANGE			MONTREAL RANGE			HALIFAX RANGE		
DOWNTOWN OFFICE	LOW	HIGH	Outlook	LOW	HIGH	Outlook	LOW	HIGH	Outlook	LOW	HIGH	Outlook	LOW	HIGH	Outlook
AA	N/A	N/A	N/A	4.00%	4.50%	◀ ▶	4.25%	5.00%	◀ ▶	4.50%	5.50%	◀ ▶	N/A	N/A	N/A
A	5.75%	6.25%	◀ ▶	3.875%	4.75%	◀ ▶	4.75%	5.50%	◀ ▶	5.25%	6.25%	◀ ▶	6.25%	6.75%	◀ ▶
B	6.25%	6.75%	◀ ▶	4.25%	5.00%	◀ ▶	6.00%	7.00%	◀ ▶	5.75%	6.75%	◀ ▶	7.00%	7.75%	◀ ▶
SUBURBAN OFFICE															
A	6.00%	6.75%	▼	5.50%	6.50%	▼	5.75%	6.50%	▼	6.00%	7.00%	◀ ▶	6.50%	7.50%	◀ ▶
B	6.75%	7.50%	▼	6.50%	7.50%	▼	7.00%	7.75%	◀ ▶	6.50%	7.50%	▲	7.50%	8.50%	▲
INDUSTRIAL															
A	6.00%	6.75%	◀ ▶	4.50%	5.00%	◀ ▶	4.75%	5.75%	▼	5.75%	6.75%	◀ ▶	6.25%	7.00%	▼
B	6.75%	7.25%	◀ ▶	5.25%	6.25%	▼	5.75%	6.50%	▼	6.50%	7.50%	◀ ▶	7.25%	7.75%	▲
APARTMENT															
High Rise	4.75%	5.50%	▼	3.60%	4.00%	◀ ▶	3.75%	4.75%	▼	4.25%	5.25%	◀ ▶	4.75%	5.25%	◀ ▶
Low Rise	5.00%	5.50%	◀ ▶	3.75%	4.50%	▲	4.50%	5.00%	◀ ▶	5.00%	6.00%	◀ ▶	5.50%	6.50%	▲
HOTEL															
Full-Service Downtown	8.00%	9.00%	◀ ▶	5.00%	6.50%	▼	7.00%	8.00%	◀ ▶	7.00%	8.00%	◀ ▶	7.50%	8.50%	◀ ▶
Full-Service Suburban	8.00%	9.00%	▼	6.50%	7.50%	▼	7.50%	8.50%	▼	7.50%	8.50%	▼	8.50%	9.50%	◀ ▶
Limited-Service Suburban	8.50%	9.50%	▼	7.00%	8.00%	▼	8.50%	9.50%	▼	8.50%	9.50%	▼	9.50%	10.50%	◀ ▶
RETAIL															
Street Front - Top Performer	6.00%	6.75%	▲	4.00%	5.00%	▲	5.00%	6.00%	◀ ▶	4.50%	5.50%	◀ ▶	5.25%	6.25%	◀ ▶
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Power Centre	5.75%	6.50%	▼	5.00%	6.00%	◀ ▶	5.25%	5.75%	◀ ▶	5.00%	6.00%	◀ ▶	5.75%	6.75%	◀ ▶
Community Commercial Centre	6.00%	6.50%	◀ ▶	5.00%	6.00%	◀ ▶	5.75%	6.75%	◀ ▶	6.00%	7.00%	◀ ▶	6.75%	7.75%	◀ ▶
Strip Plaza Anchored	5.00%	6.00%	◀ ▶	4.75%	5.25%	◀ ▶	6.00%	6.50%	◀ ▶	5.50%	6.50%	▲	6.50%	7.50%	◀ ▶
Strip Plaza Non-Anchored	5.00%	6.25%	◀ ▶	4.75%	7.00%	◀ ▶	6.75%	7.75%	◀ ▶	6.50%	7.50%	◀ ▶	7.50%	8.50%	◀ ▶

LEGEND » OUTLOOK: UP: ▲ DOWN: ▼ FLAT: ◀ ▶

Q1 2018 INVESTMENT GLOSSARY

CAPITALIZATION RATE

Cushman & Wakefield's Investor Council provides quarterly estimates of capitalization rates for the asset classes contained in this report based on our market expertise. The cap rate ranges are based on transaction data as well as demand and supply dynamics in the region. These estimates are meant to encompass the majority of assets within each class and may not represent outlier transactions or deals relating to assets with specific attributes that would significantly differentiate them.

DOWNTOWN OFFICE

CLASS AA

A best-in-class office product, with more elaborate common areas, modern construction and building efficiencies, that commands the highest rents and tends to attract stronger covenant tenants, such as banks, government, insurance companies, etc. These buildings tend to be situated close to the core within their respective markets and have excellent access to major public transit hubs. Buildings are typically larger than 750,000 SF, with 5 to 10-year tenancies and some 15-year leases for inbound tenants. Occupancy levels assumed to stabilize at close to 95% of comparable market net rates.

CLASS A

A strong-performing asset, typically between 400,000 and 700,000 SF, which is well located, and may have smaller floor plate sizes, solid amenities and less elaborate common areas. The majority of the tenants have 5 to 10-year lease commitments. Occupancy levels assumed to stabilize at close to 95% of comparable market net rates.

CLASS B

Older office product, typically in the range of 100,000 to 250,000 SF. Buildings tend to be occupied with a diversified tenant mix but lack a large anchor tenant. Shorter lease commitments occur in this asset class with the average term ranging between 5 and 10 years. Average floor plate size can be significantly smaller. Generally not connected to the subway.

SUBURBAN OFFICE / INDUSTRIAL

CLASS A

Newer high-quality suburban product, typically between 100,000 and 300,000 SF. Attracts good covenant tenants for 5 to 10-year lease terms.

CLASS B

Older suburban product that attracts a wider range of tenants and covenants for lease terms ranging between 3 and 10 years.

APARTMENT

HIGH RISE

An apartment building greater than 4 storeys in height or having more than 80 units.

LOW RISE

Any apartment complex having fewer than 80 units.

HOTEL

FULL-SERVICE

A hotel with extensive dining and meeting facilities. Quality ranges from upscale to luxury. Examples include Hilton, Westin, Hyatt, etc.

LIMITED-SERVICE

A room-focused hotel with minimal facilities. Quality ranges from economy to mid-scale. Examples include Comfort Inn and Super 8.

RETAIL

STREET FRONT – Top Performer

Typically considered the street or section thereof where the greatest dollar value psf is generated from streetfront retail stores within each market.

REGIONAL MALL – Top Performer

Top-performing fully enclosed mall. These buildings tend to be greater than 800,000 SF and have a wide product offering, featuring destination retailers and 2 to 3 anchor tenants. Often located near large transit hubs and serve a trade area between 10 and 30 kilometres.

POWER CENTRE

Large format, category dominant retailers in an open-air configuration that may include "club" or discount department stores. Total GLA is typically between 100,000 and 1,000,000 SF.

COMMUNITY COMMERCIAL CENTRE

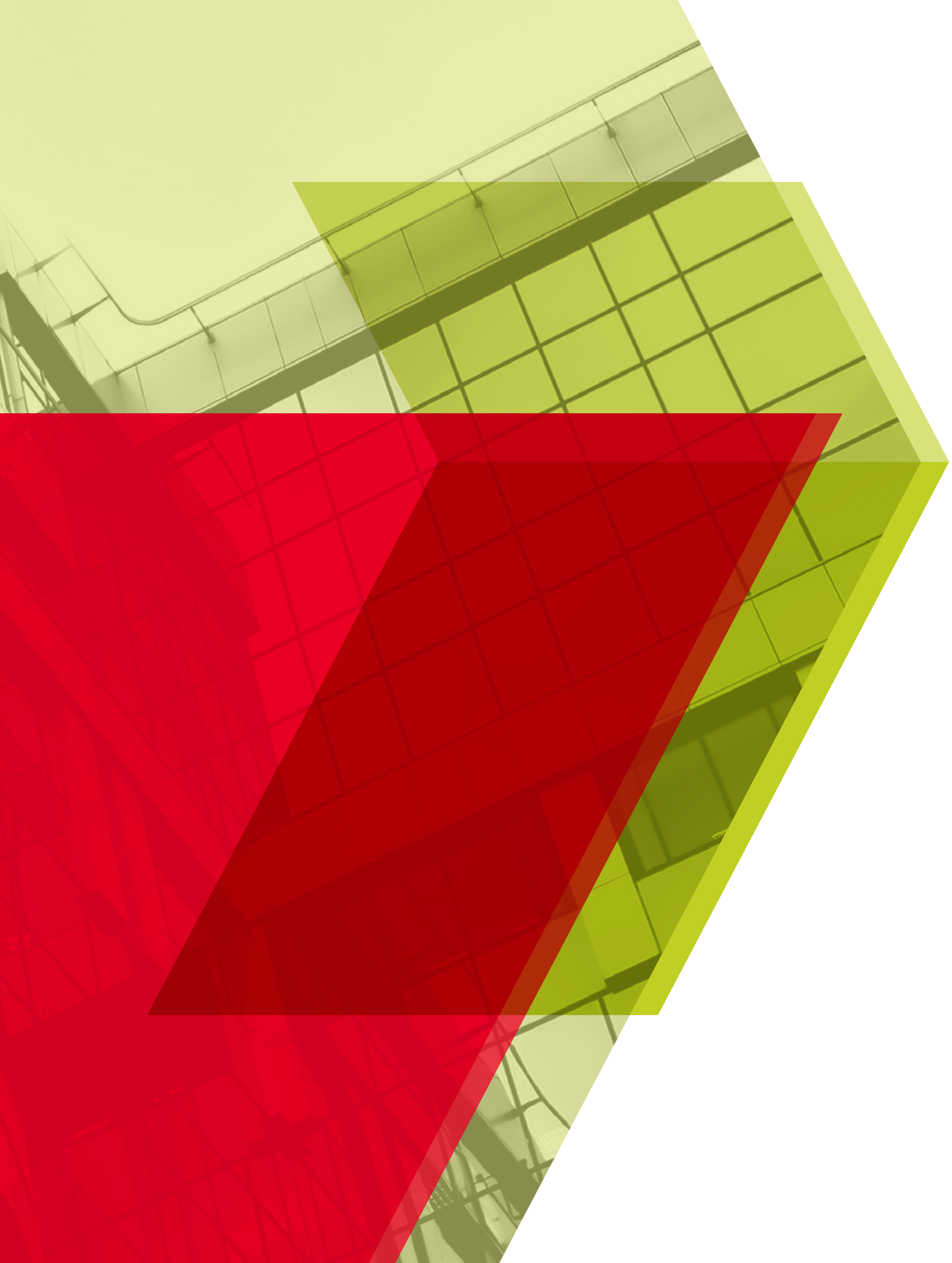
An enclosed centre anchored by a smaller department store, servicing a local community. Tenants may include general merchandise and convenience offerings, including a grocery store. Total GLA is typically between 100,000 and 400,000 SF.

STRIP PLAZA – Anchored

An open-air configuration of attached retail stores that may include retail PAD sites. They are often anchored by a food or drug store tenant. Tenants are generally servicing residents in the neighbourhood. These would include dry cleaners, take-out food stores, convenience stores, etc.

STRIP PLAZA – Non-Anchored

An open-air configuration of attached retail stores, not anchored by a grocer or drug store, that may include retail PAD sites. Tenants are generally servicing local neighbourhood residents.



IDEAS INTO ACTION

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