Canadian Real Estate: Too Much Of A Good Thing?

By: Tom Johnston & Catherine Ann Marshall

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When it comes to investing in property, the principle 'don't put all your eggs in one basket' takes a back seat to the adage 'real estate is a local business.'

Investors have a home market bias toward real estate that seems to over-ride the importance of diversification, in marked contrast to their approach in some other asset classes.

As the popularity of direct property investment has increased, Canadian commercial real estate has been transformed from a developer-led business to an institutionally managed one. Institutional investors credit this change for increased market safety and low volatility, which has conferred 'safe haven' on Canada with a resultant price premium.

But given the popularity of Canadian real estate, the next adage to consider is 'too much of a good thing?' Over the past 10 years, the annualized return on Canadian institutional grade real estate has been 11.9 per cent, says the REALpac/IPD direct property index. This makes Canada the top performing market in the developed world during that period, outperforming the U.S. and UK by 350 and 560 basis points respectively (See *Chart 1*).

Rear View Mirror

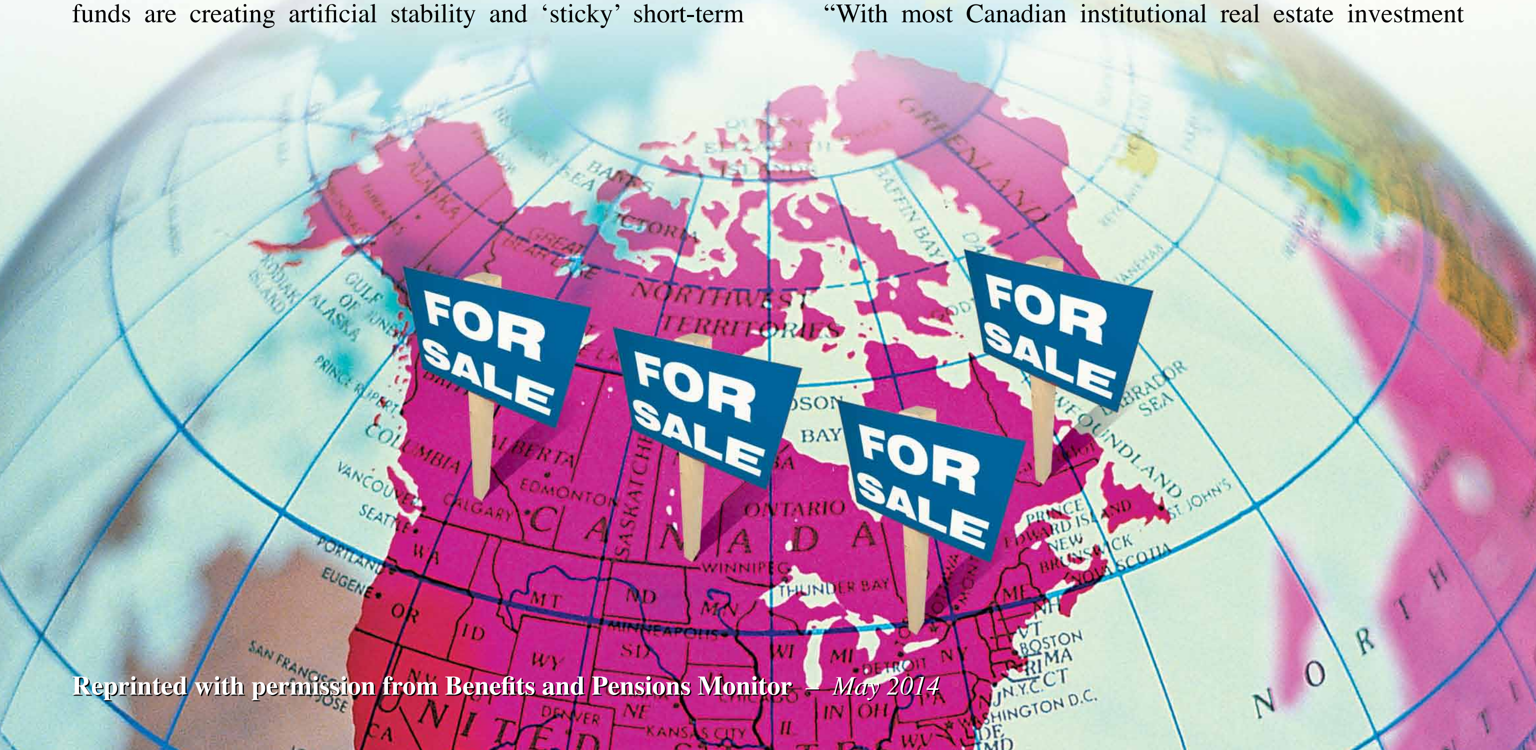
Benjamin Abramov, associate partner and Canadian head of private markets research at AON Hewitt, says that pension funds are creating artificial stability and 'sticky' short-term valuations because they dominate the real estate market and tend not to sell prime assets. That may be the real reason for Canada's low volatility and perceived stability (See *Chart 2*), which included the relatively small capital loss of just 11 per cent following the financial crisis (compared to -32 per cent and -42 per cent in the U.S. and UK respectively).

"A structural home market bias may create long periods of over valuation. Investors are also sometimes guilty of investing by looking at the rear view mirror," he says.

It isn't just Canadians who are wondering about current overvaluations. In a recent speech in New York, Simon Fairchild, IPD managing director, questioned whether prices are adequately matched to today's risks. He presented data that showed that if Canadian pricing were to revert to the mean, then going-in yields would rise from the 2013 year-end value of 5.4 per cent to seven per cent. In a long-lived asset like real estate, that yield shift would have a significant negative impact on prices.

Richard Johnson, managing director at UBS Global Asset Management, agrees with that perspective. Appearing before a Canadian institutional audience earlier this year to highlight the risks of over-exposure to Canadian commercial real estate, he showcased research which concluded that Canadian valuations appear to be stretched because of the pressure of large amounts of capital focused on Canada's limited inventory of commercial real estate.

"With most Canadian institutional real estate investment



focused on domestic real estate, pension funds could be seriously overexposed in the event of a downdraft in the market," says Johnson. "At the same time, we are expecting attractive returns over the intermediate term in some markets in Europe and Asia, so this is an excellent time to think about diversification and look at opportunities in those markets."

Opportune Time

Abramov says investors are least likely to take advantage of diversification opportunities when home markets are performing well. However, he agrees that this is the most opportune time to redeploy investment capital into the international market. "We believe that other core markets (outside Canada) can generate between one-half to one per cent of longer term outperformance, depending on the market.

"Although we are not recommending that clients entirely abandon the domestic market, given it has a role in protecting against local inflation and is not expected to have negative returns, we are certainly actively talking to clients about adding exposure to more attractive markets that also provide diversification.

"Given the full valuation and the potential for downside risks, there is a strong argument for diversification," he adds. He thinks the major risks to the overall economy and, therefore, commercial real estate demand include a potential 'bust in the housing cycle,' weaker commodity prices, a consumer slowdown, and the challenging export environment.

SCANning The Future

Johnson's presentation included an analysis of the SCAN countries (Switzerland, Canada, Australia, and the Netherlands). These countries have similarities that are – or will – put them at the forefront of global investing. The Netherlands is the most diversified and Australia the least. But given their strong demand for real estate and their very small domestic markets, UBS' real estate strategy group predicts that the SCAN countries are likely to become increasingly significant global investors.

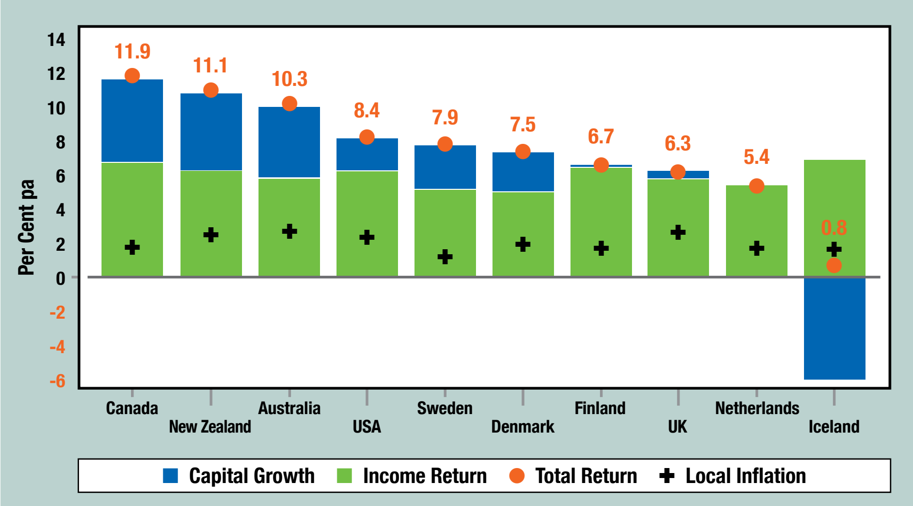
The common threads among the SCAN countries are:

- pools of institutionally managed retirement capital that are very large relative to country GDP
- very small real estate markets each representing just two per cent of the world's investable real estate
- high and rapidly increasing institutional investment in real estate

These factors result in institutions owning a significant part of their own domestic market with the Netherlands and the Swiss leading the way with ownership levels of about 80 per cent. In contrast, Canadian institutions are estimated to own about 60 per cent of the investable market, while the Australians own just over 50 per cent (See *Chart 3*).

Chart 1

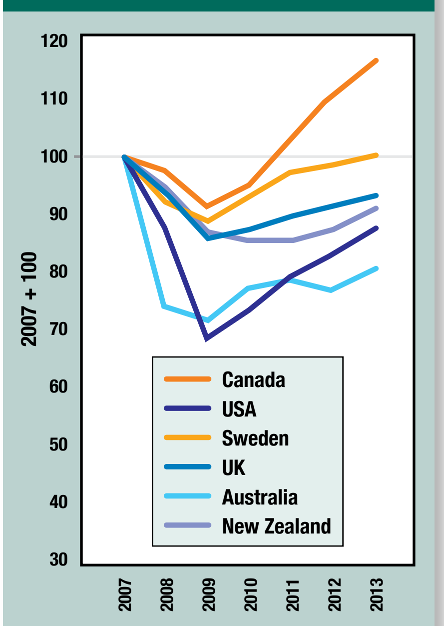
10-year Annualized Based On Local Currency



Source: IPD.

Chart 2

Progessed Recoveries



Source: IPD.

Dutch Leadership

Dutch pension funds were early investors in global real estate and are reported to hold up to 70 per cent of their real estate offshore today. Their international investment programs are among the most mature in the world as they concluded almost 30 years ago that they had to diversify globally as their home market would not be able to absorb future demand. That impetus was supported by Dutch financial institutions that used their growing global footprint to provide international real estate products and by early global investment pension organizations like the Association of Foreign Investors in Real Estate (AFIRE), founded in 1988.

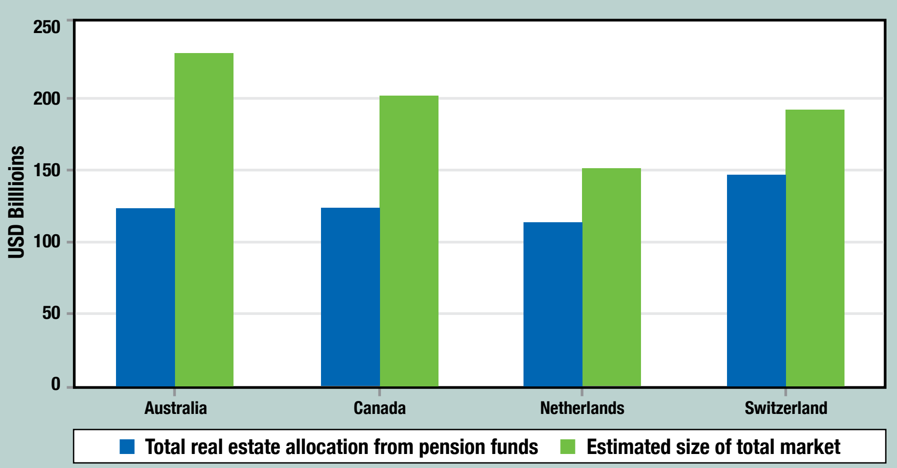
"Lack of ability to diversify adequately within the country has been widely discussed in the Netherlands for a long time," says Gunnar Herm, UBS European head of research. He says the Dutch were also culturally attuned to investing in global real estate because of their long history as merchant traders and colonizers.

The Swiss are thought to have about 25 per cent of their real estate investment offshore. Herm says that the Swiss are increasingly aware of the pressure of 'captive capital' on their home market and look to the Dutch example as a solution. "What has kept their investment at home was the perception that every other market was a lot more risky, but they are starting to see the risk they are creating because the market is too small to absorb all the capital that they want to invest" (See *Chart 4*).

Currently, Australian off-shore investment is estimated to be less than 20 per cent of their real estate holdings. In the years leading up to the crisis, the pressure of capital drove the spread of going-in real estate yields over bonds to less than 50 basis points, forcing investors abroad. After 2008, real estate spreads over bonds blew out as much as 400 basis points and investors repatriated capital from foreign markets. A recent analysis by global brokerage Jones Lang Lasalle suggests that the return of capital pressure means Australian institutions may own all the investable real estate in the country by 2020.

Chart 3

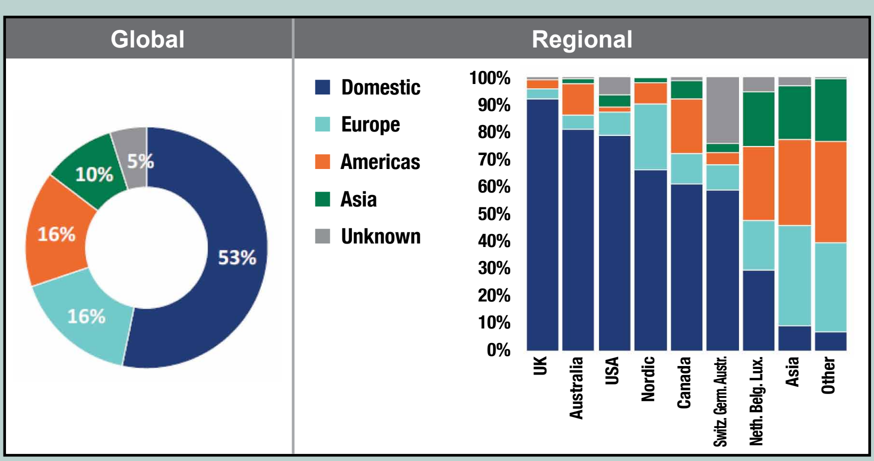
Domestic Real Estate Market (by invested stock) Against Pension Fund Allocatioins



Source: IPD, OECD Global Pension Statistics, DTZ Money into Property: UBS Global Asset Management, Pension Fund Indicators 2012, as of December 2012.

Chart 4

Geographic Exposure Of Real Estate Portfolios In The Sample Universe



Source: IPD, MSCI.
Note: Based on 138 asset owners in Survey Universe. Calculated on % or real estate assets in each category, not number of asset owners.

Diversifying Globally

In Canada, the most sophisticated institutions are also aware of the risks and are diversifying globally. There are no official estimates of international real estate investment by Canadian pension plans, but a few of the largest pension plans have sizable foreign real estate investments. A recent survey of large Canadian plans by IPD showed they had 40 per cent of their real estate assets offshore.

But many large plans are just in the early stages of international real estate investing. And some other large plans, and most medium- and small-sized funds, currently have none. A Greenwich Associates survey showed that overall, just four per cent of Canadian plans surveyed planned to hire global real estate managers in 2012.

"Canadian real estate has been a good investment for institutions and has helped them to learn first-hand about the benefits of property in their asset mix," says Johnson. But, looking forward, there are even greater benefits to be gained by "going global" in real estate, he says. BPM

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