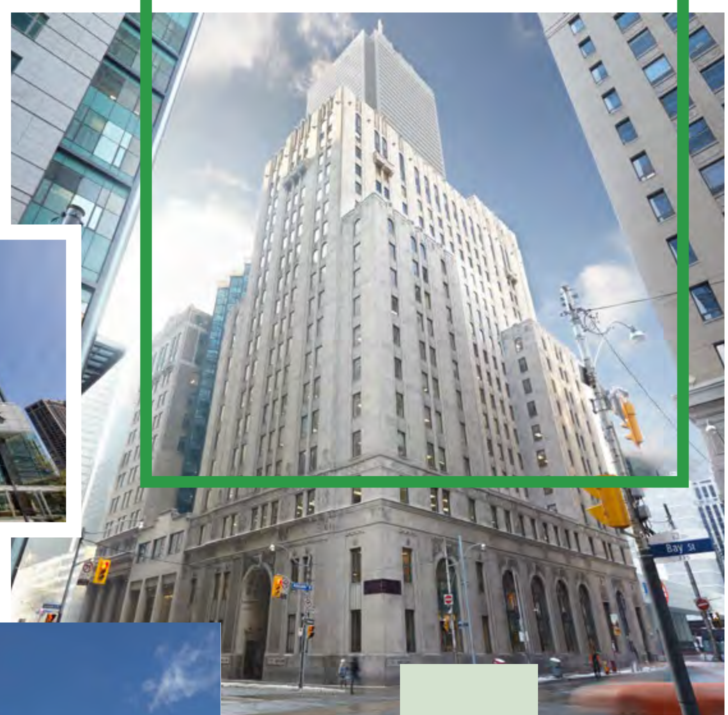
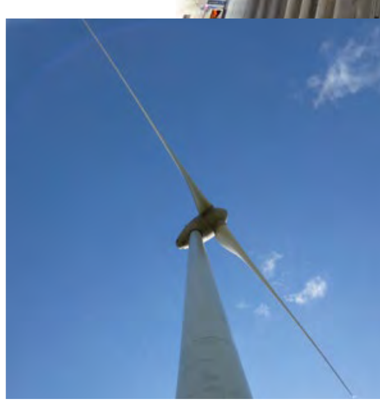
TD Asset Management

Real Assets Market Report + 30 Minutes = New Thinking

Real Assets Market Report

Q4 2019





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Investment and Economic Outlook

At this point, it seems that we are enduring the third mini slowdown within a very long cycle. We are seeing some early economic indicators bottom out or turn up from their recent lows, which is encouraging.

Since the global financial crisis and subsequent recession, the economy has witnessed a prolonged yet steady recovery at the lowest growth rates on record. Combined with low inflation, central banks have been afforded latitude to deploy stimulative measures for longer periods to help maintain a steady economic course, with relatively fewer interest rate hikes in between. This central bank balancing act has helped extend the current cycle and may propel equity markets even higher in 2020.

Within alternatives, sound fundamentals across property types have allowed for year-over-year net operating income growth, particularly in real estate assets that are located in transit-linked nodes within major urban areas. Projections for robust population growth is expected to tighten demand and supply dynamics, while the role of e-commerce and technology will transform uses within retail and industrial assets. We believe active management will play a critical role to preserve capital and grow multi-generational income streams over the long term.

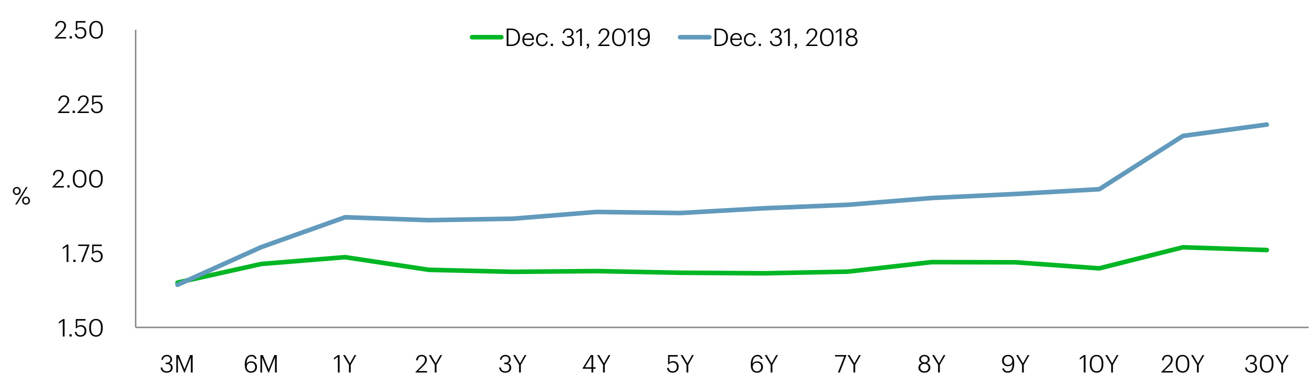
We continue to view commercial mortgages as more attractive versus corporate bonds. Prime rate floating mortgages, which are used on real estate at earlier stages of the real estate life cycle, have become increasingly attractive. Our strategy heading into 2020 is focused on combining value-add opportunities within floating prime rate loans with stable high-quality term loans. We believe this pairing can provide higher risk-adjusted returns, facilitate less duration risk and more nimble capital deployment.

We believe that direct, private infrastructure investments provide stability and income to a portfolio, but also can benefit from an active investment approach as we enter the late stages of the economic cycle in 2020.

Canadian Mortgage Market

Commercial mortgages provided strong returns in 2019 as steady income and lower Government of Canada ("GoC") yields more than offset the modest spread widening that took place over the year. The GoC yield curve ended the decade almost entirely flat, and despite experiencing a slight uptick from the third quarter, GoC yields remain near historic lows.

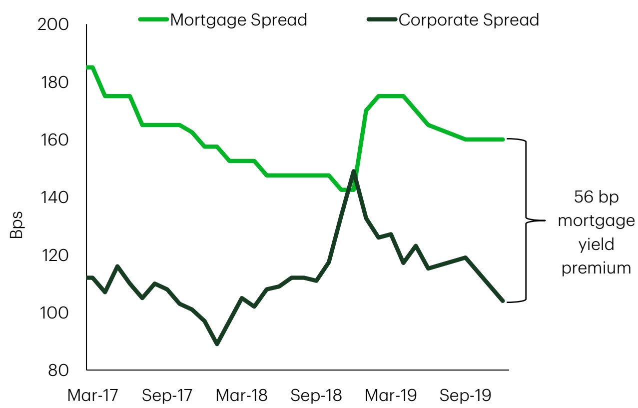
Figure 1 - Government of Canada Yield Curve



Source: Bloomberg Financial L.P. As at Dec 31, 2019.

Following tightening spreads through the second and third quarter of 2019, commercial mortgage spreads took a pause during the final three months of the year. Meanwhile, strong equity performance spilled into the credit market and compressed corporate bond spreads to just over 100 basis points ("bps").

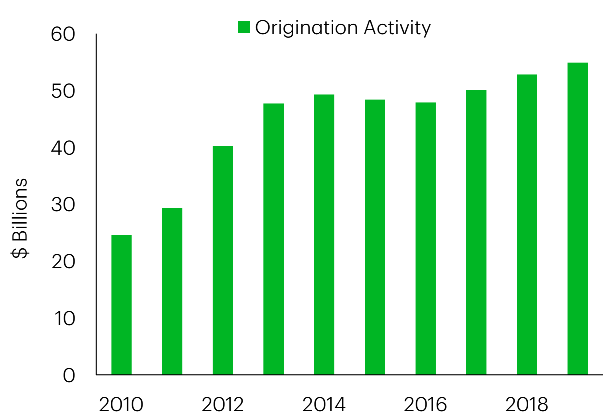
Figure 2 - Commercial Mortgages vs. Corporates



Source: TD Asset Management, CMLS Financial, Bloomberg Barclays Canada Aggregate Corporate Total Return Index Value Unhedged CAD. As at Dec 31, 2019.

Tight commercial real estate fundamentals continue to draw capital into the market. As depicted in Figure 3, Canadian commercial mortgage origination activity is estimated to have reached over $54 billion in 2019.

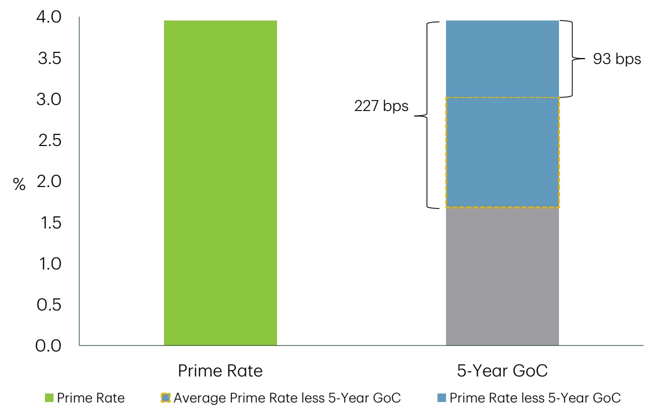
Figure 3 - Active Commercial Real Estate Lending Market



Source: CMLS Financial. As at Dec 31, 2019.

Conventional Plus commercial mortgages secured by real estate in the earlier stages of the asset's life cycle continue to provide significant yield accretion. The total yield earned is improved due to the use of a floating Prime Rate basis as opposed to GoC yields which are typically used for conventional term loans. The difference between the Prime Rate and the 5-Year GoC yield, for example, is near a historic high of 227 bps, 93 bps above the average premium since 2009.

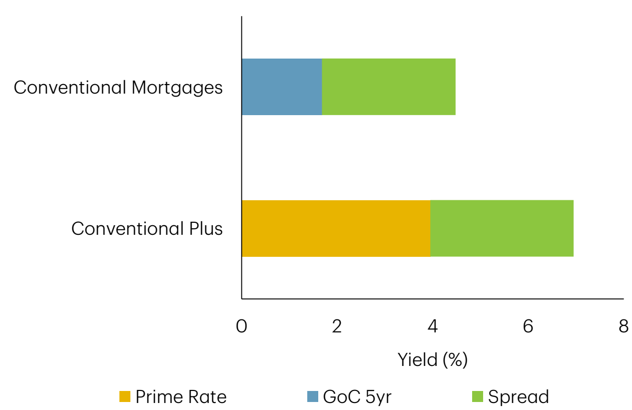
Figure 4 - Prime Rate Significantly Higher than 5-Year GoC



Source: Bloomberg Financial L.P. Average yields between Jan. 1 2009 – Dec. 31, 2019. As at Dec 31, 2019.

Managers with extensive commercial real estate experience and robust risk controls are able to add this additional income stream to portfolios. Rather than solely searching for incremental yield within conventional term mortgages, investors can pair the premium yields of Conventional Plus loans with the stable return profile of top-tier conventional term mortgages for a compelling total portfolio strategy.

Figure 5 - Prime Rate Lending More Attractive than Moving Out Term Loan Risk Curve



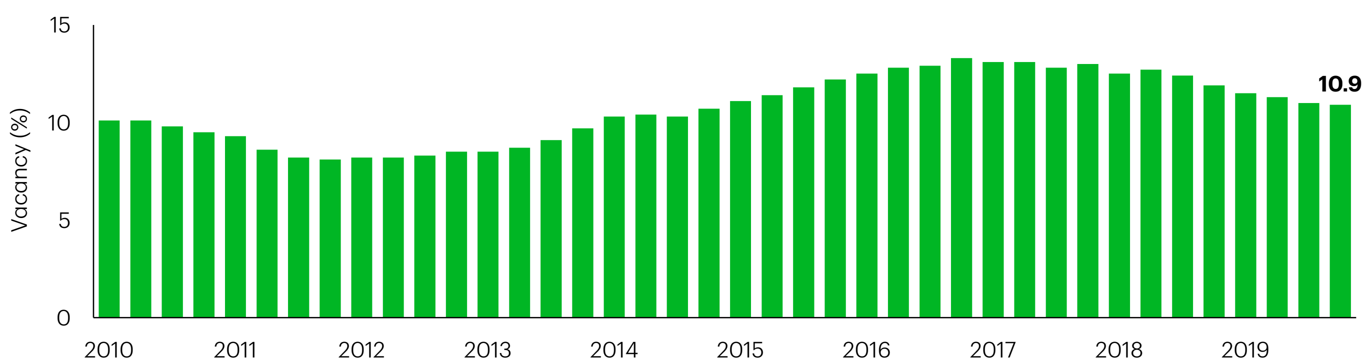
Source: Bloomberg Financial L.P., CMLS Financial. As at Dec 31, 2019.

Canadian Commercial Real Estate Market

Office

To end Q4 2019, the national office vacancy contracted by 50 bps annually to 10.9%, which is the lowest it has been in five years (see Figure 6)

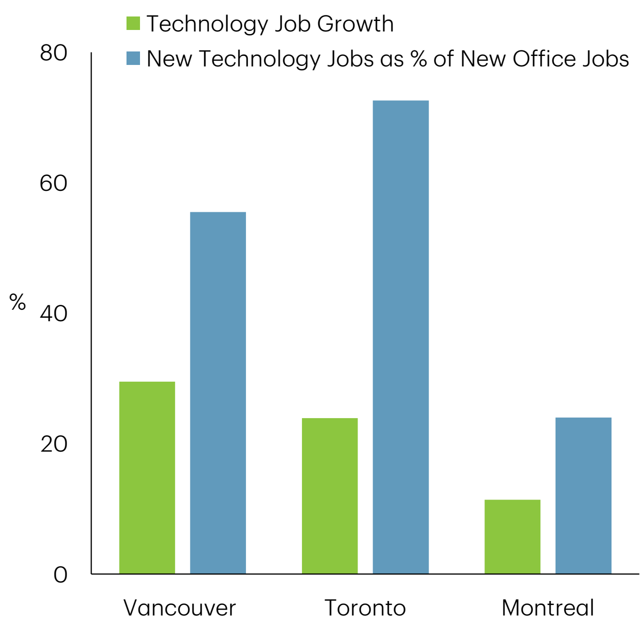
Figure 6 - Lowest Office Vacancy in Five Years



Source: CBRE Research. As at Dec 31, 2019.

Canada witnessed robust employment gains throughout 2019, resulting in an unemployment rate of 5.7%, to end the year, the lowest it has been since 1976.[1] High job growth particularly in the technology and FIRE (finance, insurance and real estate) sector in Vancouver, Toronto and Montreal translated into the majority of new office jobs within these major cities.

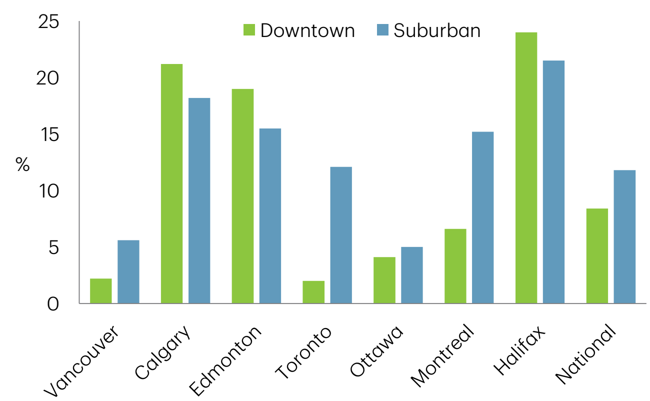
Figure 7 - Technology Job Growth Drives the Majority of New Office Jobs



Source: CBRE Research. Represents growth between 2017 and 2018. As at October 24, 2019.

The majority of leasing continues to occur within core downtown locations. Interestingly, 2019 saw suburban markets improve with positive absorption (demand) overall. However, on a national level, tenants and investor sentiment is skewed towards downtown locations, indicated by the lower downtown vacancy rate and higher rental rate growth versus the suburban market.

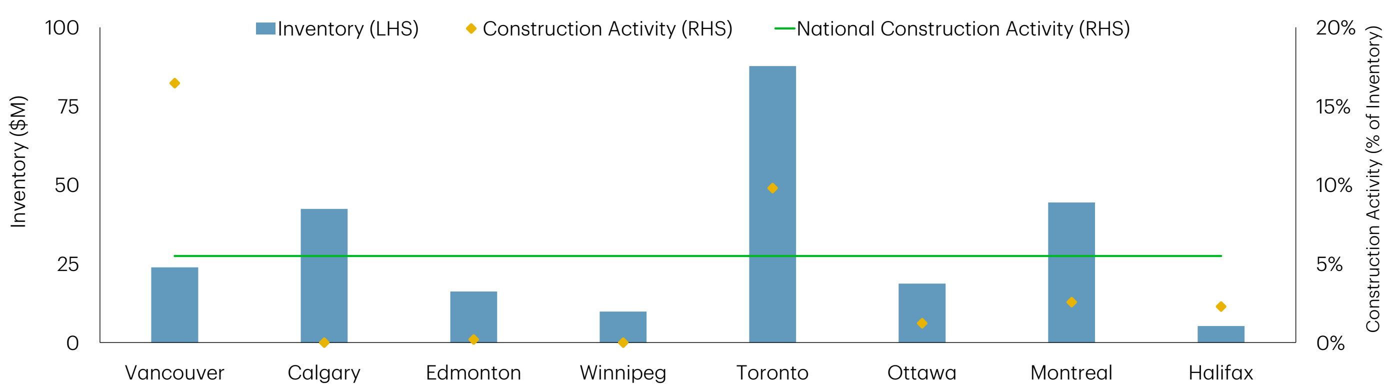
Figure 8 - Strong Tenant Preference for Downtown Locations



Source: CBRE. As at Dec 31, 2019.

While downtown Vancouver and Toronto are experiencing above average construction activity, we expect it to do little to help alleviate excess demand as 80% and 64% of the upcoming supply has already been preleased, respectively.[2] Conversely, construction activity has halted in Calgary and Edmonton given recent oversupply.

Figure 9 - Robust Office Demand in Vancouver and Toronto Has Led to an Active Construction Pipeline



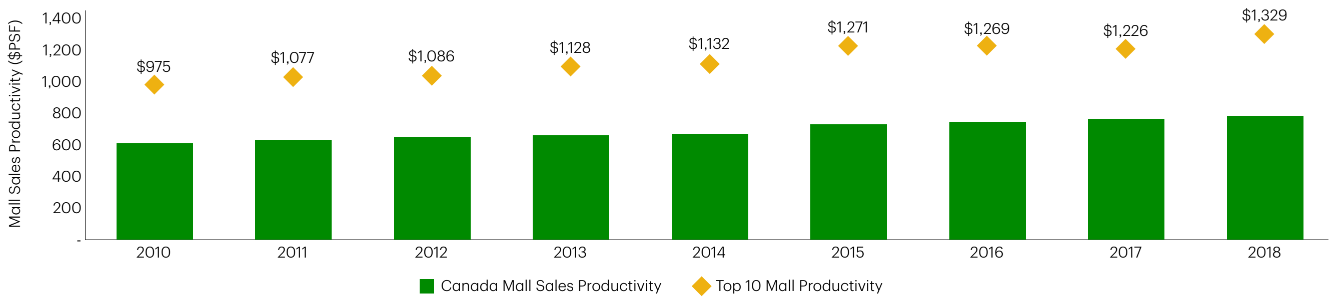
Source: CBRE Research. As at Dec 31, 2019.

[1] Statistics Canada. Dec 2019.
[2] JLL. Dec 2019.

Retail

Mall sales productivity across Canada has shown steady increases year over year and the top 10 most productive malls continue to trend upwards (see Figure 10).

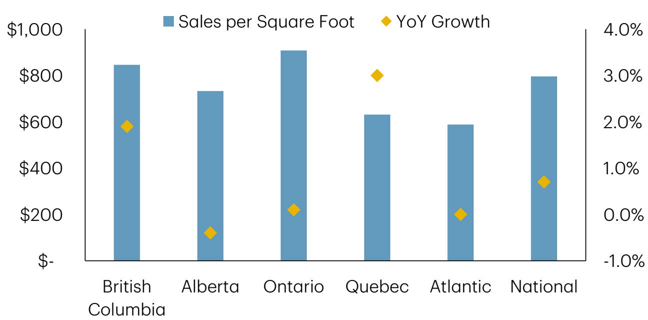
Figure 10 - Canadian Mall Productivity Continues to Trend Upwards



Source: CBRE Research. As at Dec 31, 2018.

Apple, Tesla, Aritzia and Lululemon, are the common tenants across the top ranked shopping centres, given their proven ability to deliver experiential and omni-channel retailing that consumers demand. In particular, Apple has been regarded as an anchor tenant due to its ability to drive significant foot traffic and strong sales productivity. Geographically, British Columbia and Ontario saw positive sales per square foot growth, with the highest growth experienced in Quebec (see Figure 11).

Figure 11 - Quebec Leads in Annual Sales per Square Foot Growth

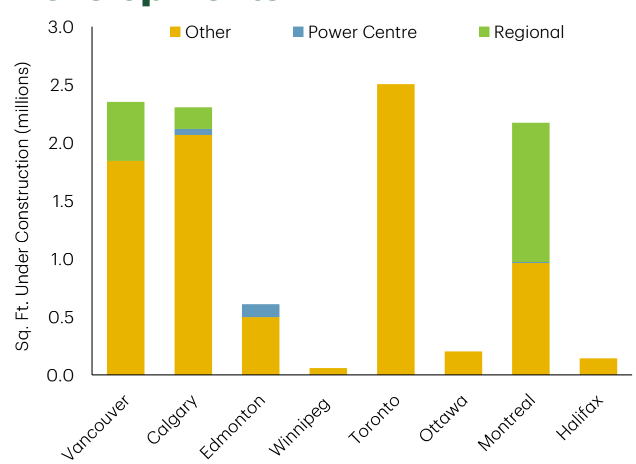


Source: ICSC Industry Insights. As at Oct 31, 2019.

Canada continues to be an attractive market for international retailers, 30 new brands entered the country in 2019.[3] The primary entry point for these retailers is Toronto, followed by Montreal and Vancouver. In 2019, many of the new retail entrants to Canada were luxury brands from Europe. Additionally, U.S. retailers are expanding to Canada, often due to maturity in their local markets and appetite for further market share.

Toronto, Vancouver and Montreal are experiencing relatively higher levels of square feet under construction in comparison to other cities. Research conducted by ICSC has shown that 87% of Canadians would consider living in a "live, work, shop, play" environment[4] As a result, the majority of this construction is classified as "other", which includes mixed-use developments. Vacant Sears and Target spaces present landlords with the opportunity to respond by incorporating retail strategies as a focal point to a broader mixed-use development.

Figure 12 - Upcoming Retail Supply is Strategically Incorporated into Mixed-Use Developments



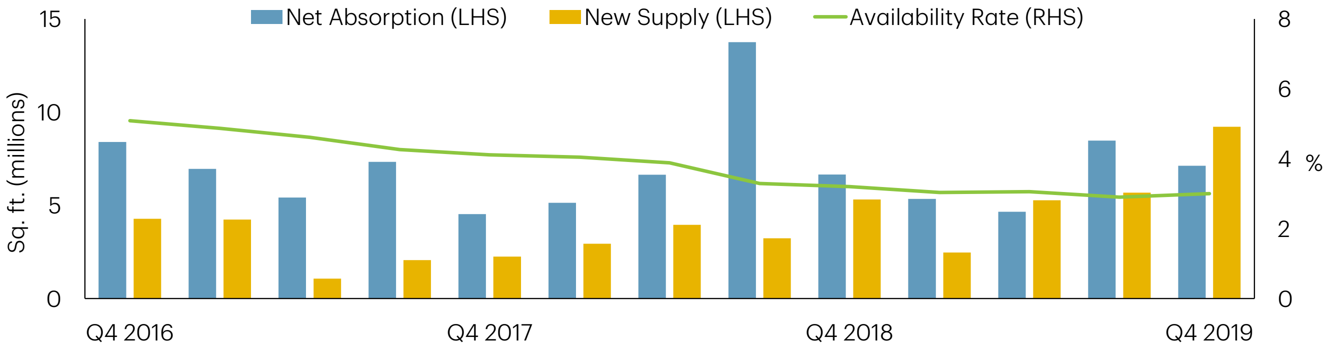
Source: CBRE Research. As at June 30, 2019. Other includes mixed-use, community and neighbourhood retail formats

[3] Retail Insider. January, 2020.
[4] Retail Council of Canada. December, 2019.

Industrial

The national industrial availability rate to end 2019 was 3.0%, representing a 10 bps increase over the previous quarter. This slight increase can be attributed to a needed deployment of new supply into the market that continues to see record low availability rates (see Figure 13).

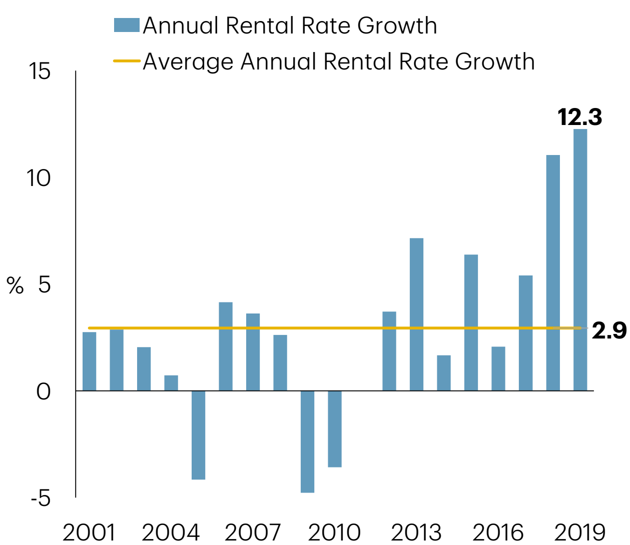
Figure 13 - Delivery of New Supply Helped Availability Rates Hold Steady



Source: CBRE Research. As at Dec 31, 2019.

Despite new supply in 2019 surpassing new supply delivered in the previous year, rental rates experienced the largest historical growth over an annual period, illustrating the exceedingly wide demand and supply imbalance (see Figure 14). Demand is primarily driven by e-commerce, third-party logistics and distribution type tenants who are willing to pay a significant premium to be located in highly accessible locations (i.e., direct access to major highways) and in state-of-the-art facilities required to meet evolving consumer expectations (i.e., last mile delivery).

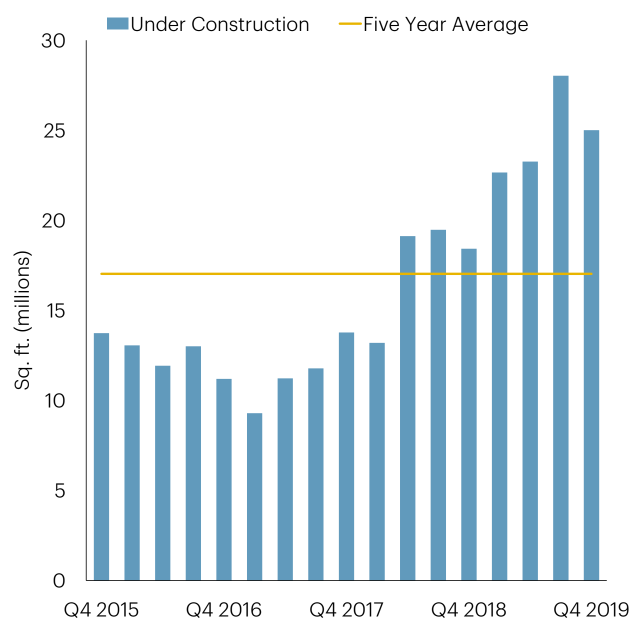
Figure 14 - Largest Annual Rental Rate Increase on Record



Source: CBRE Research. As at Dec 31, 2019.

Currently, construction activity for new industrial product is the highest it has been over a five year historical average period (see Figure 15). However, we still expect demand to exceed supply in 2020 across most major markets. The majority of the upcoming supply is unlikely to alleviate low vacancy rates in Vancouver as new supply is build-to-suit or already preleased. In Toronto, vacancy is expected to trend slightly upwards given a large pipeline of supply, but will still likely be below its historical averages .

Figure 15 - Industrial Pipeline above Five Year Average

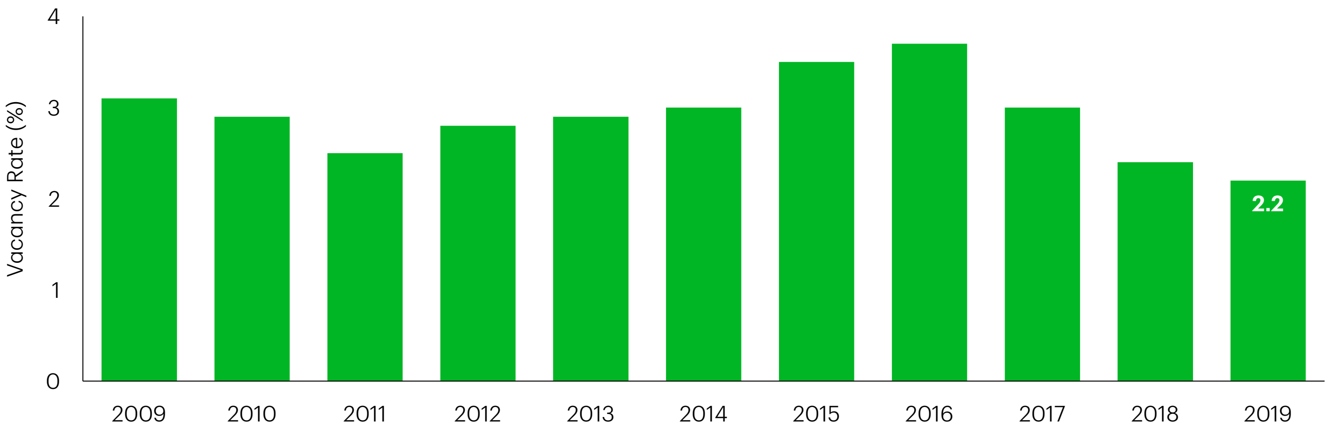


Source: CBRE Research. As at Dec 31, 2019.

Multi-unit Residential

Between 2018 and 2019, the average national vacancy rate across Canada dropped 20 bps to 2.2%, below its 10 year average of 2.9%.

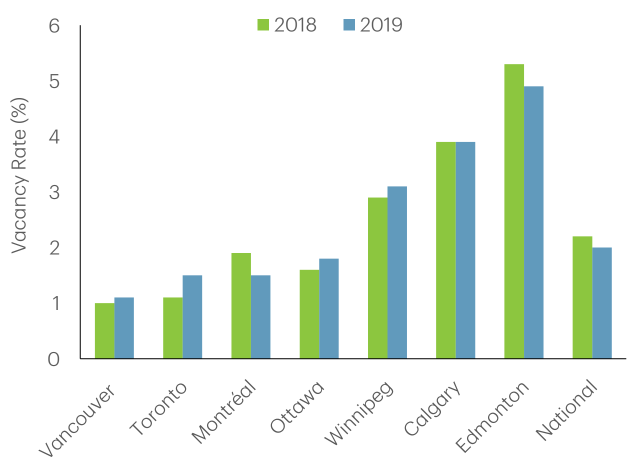
Figure 16 - Vacancy Rate Remains Below Historical Average



Source: CMHC Research. As at Oct 2019.

Generally, all major cities saw a decline in vacancy, with the exception of Toronto and Vancouver, as a result of some relief from incremental increases in supply within the primary and secondary markets (Figure 15).

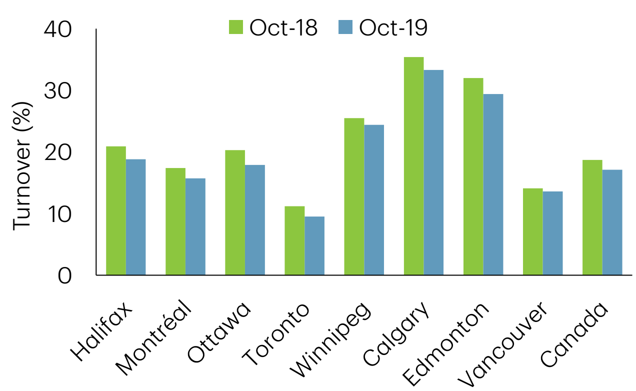
Figure 17 - Toronto and Vancouver Exhibit the Lowest Vacancy Rates across the Country



Source: CMHC Research. As at Oct 31, 2019.

Despite this marginal relief, demand in Toronto and Vancouver still remains high, resulting in 6.5% and 6.0% rental rate growth, respectively, above the national average of 5.1%. Consequently, rising market asking rents tend to be above what existing renters are paying, hindering willingness/ability to move into another unit, measured by tenant turnover (see Figure 18).

Figure 18 - Higher Asking Rents Have Reduced Turnover



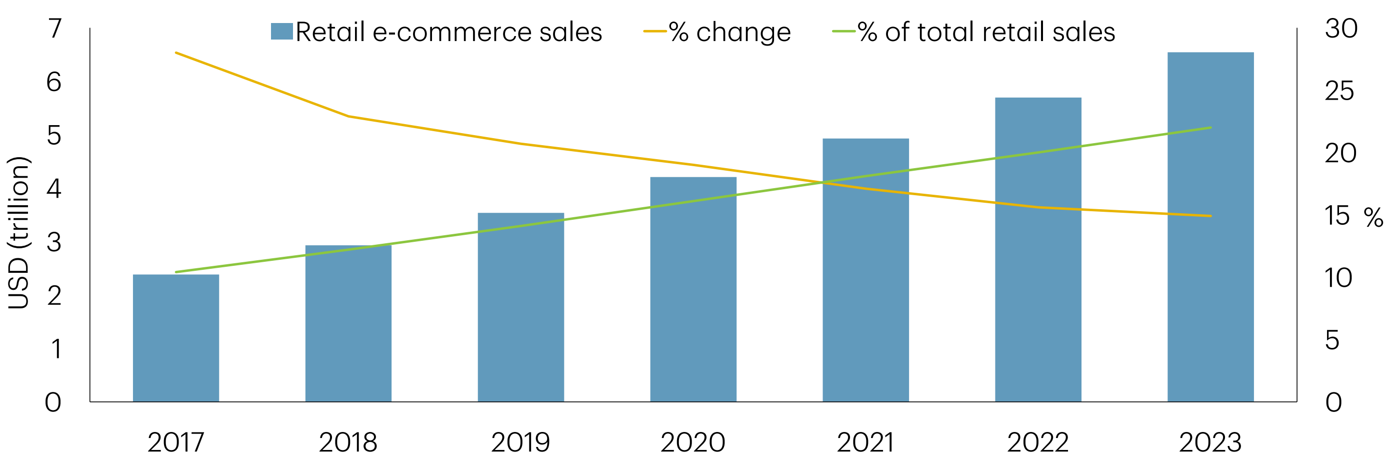
Source: CMHC Research. Oct 2019.

Multi-unit residential fundamentals remain robust, driven by a combination of newly-formed households of younger age groups and immigrants, which tend to be key demographics due to their higher propensity to rent. For example, within the Greater Toronto Area, individuals within the age 25-44 demographic cohort saw the strongest year-over-year growth at 4.9% . Going forward, we believe that being located in major urban nodes will benefit from this favourable demographic shift.

Global Commercial Real Estate Market

The industrial market has seen strong growth across the world. Structural changes such as e-commerce, technological advances, global trade, supply chain reconfiguration, changing consumer behavior and demographics are leading to increased demand for industrial space by tenants. It is estimated that for every US$1 billion in incremental e-commerce sales, there is a need for 120,000 square metres / 1.3 million square feet of additional warehouse space.[5]

Figure 19 - Expected E-Commerce Sales Worldwide, 2017 – 2023

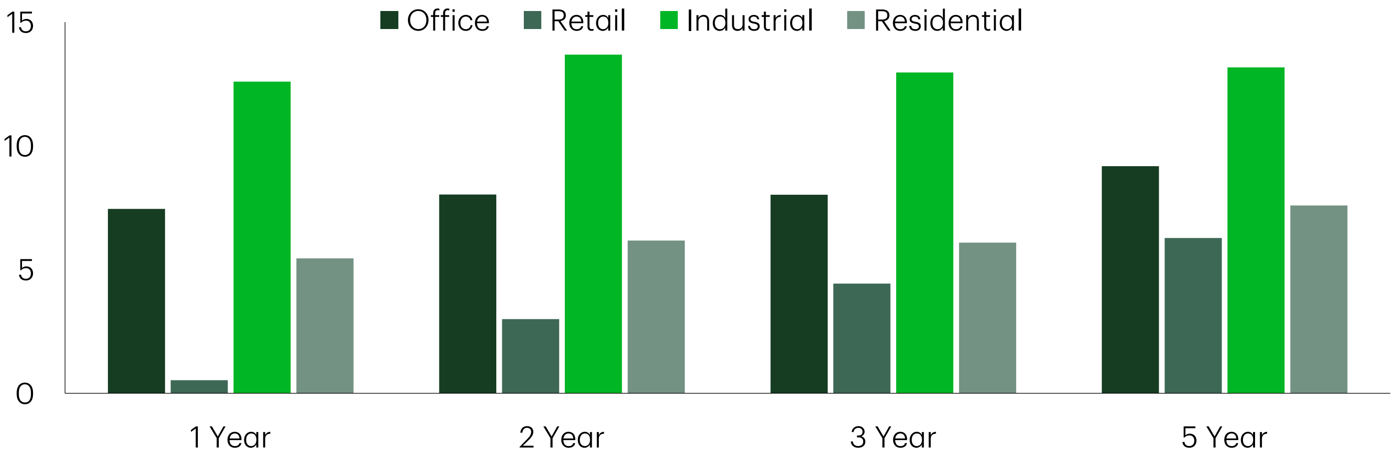


Source: eMarketer. As at May 31, 2019. Includes products or services ordered using the internet via any device, regardless of the method of payment or fulfillment; excludes travel and event tickets, payments such as bill pay, taxes or money transfers, food services and drinking place sales, gambling and other vice good sales.

[5] CBRE Research 2018.

Investors are attracted to this sector given the robust tenant demand, declining vacancies and rental growth potential.

Figure 20 - MSCI Global Property Index – Total Return



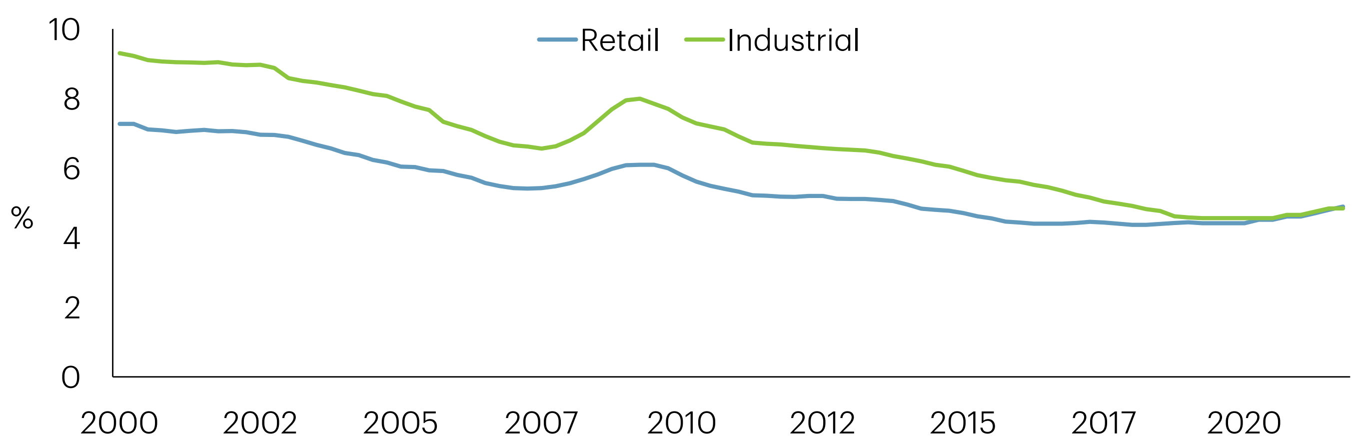
Source: MSCI. As at Sep 30, 2018.

Historically, capitalization rates for industrial properties have been about 140 basis points above that of retail properties. That has now compressed to approximately 15 basis points. This is largely a result of the supply and demand imbalance within this sector.

There has been a lack of modern logistics facilities across the world to meet the growing demand for space. This is a consequence of government regulations, lack of developable land and escalating construction costs. Governments tends to prefer mixed-use, retail and office properties as they tend to generate significant tax revenues to municipalities. As a result, more industrial zoned lands are being converted into alternative uses and thus reducing the available land supply.

Industrial properties are more cyclical compared to other institutional property types. However, looking forward we believe that the structural changes taking place within this sector will dampen some of the volatility that may occur from an economic downturn or trade tensions. We anticipate this property type to be one of the strongest performance contributors to a diversified global real estate portfolio.

Figure 21 - Global Capitalization Rate by Property Type



Source: CBRE Research & Econometric Advisors. As at Sep 30, 2019.

Global Infrastructure

One of 2019's investment themes seems to have been uncertainty. Despite ushering in some of the largest equity gains of the past ten years, investor sentiment was at its lowest. Geopolitical fears weighed heavily as the current expansion became one of the longest in history and yield curves inverted early in 2019. Global trade negotiations, uncertainty over Brexit, tension in the Middle East and the rise of nuclear threats globally kept some investors on the sidelines.

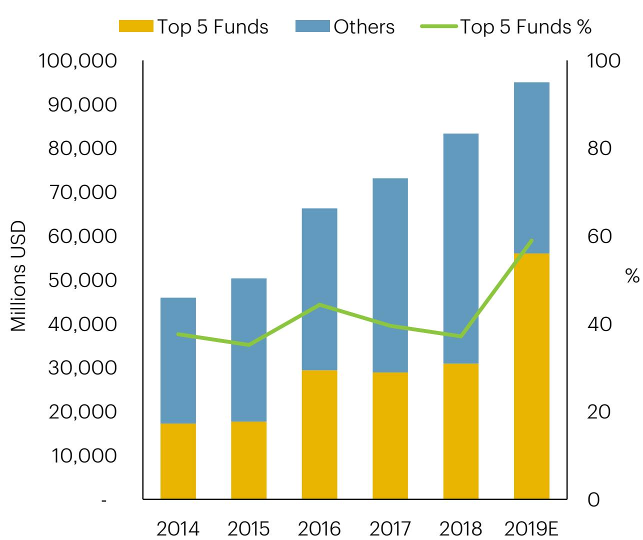
With this global backdrop we saw an increasing number of infrastructure investors come back to do deals in North America, which continues to offer solid macro-economic fundamentals. We believe North America offers attractive risk adjusted returns, given the region's relative population growth and ability to maintain central bank rates above zero, notably in Canada

2019 Infrastructure Fundraising Activity

According to Preqin, 2019 continued the significant fundraising momentum we've seen in private infrastructure with US$98 billion raised globally. However, concentration continued to increase to the largest managers as 2019 marked an increase in capital raised, but a decrease in the number of funds raising capital. Only 88 funds reported closings to date in 2019 as compared to a high of 122 funds in 2017.

Over the last five years, we've seen over 40% of capital raised go to the top five managers each year. Infrastructure funds continue to get bigger with the top managers raising multi-billion dollar funds, including early closes for two $20 billion funds in 2019. According to Preqin, dry-powder is at its highest in the industry and this is increasing competition for the largest assets globally and pushing down returns for those large assets (greater than $1 billion of equity).

Figure 22 - Majority of Capital Raised by Top 5 Funds

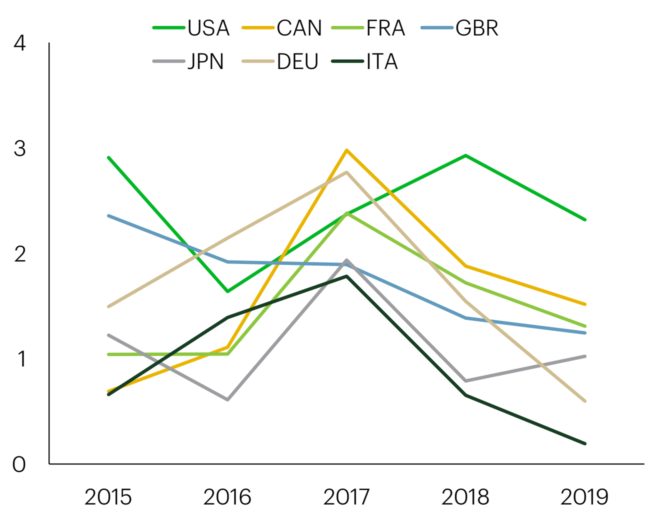


Source: Preqin. As at Dec 31, 2019.

2019 Infrastructure Transaction Activity

With all of the geopolitical tensions around the world in 2019, we saw the value of deals completed increase in North America. Despite headwinds, both Canada and the U.S. had strong economic performance throughout 2019, with some of the strongest GDP growth among G7 nations, robust labour markets and continued population growth.

Figure 23 - G7 GDP Growth Rates

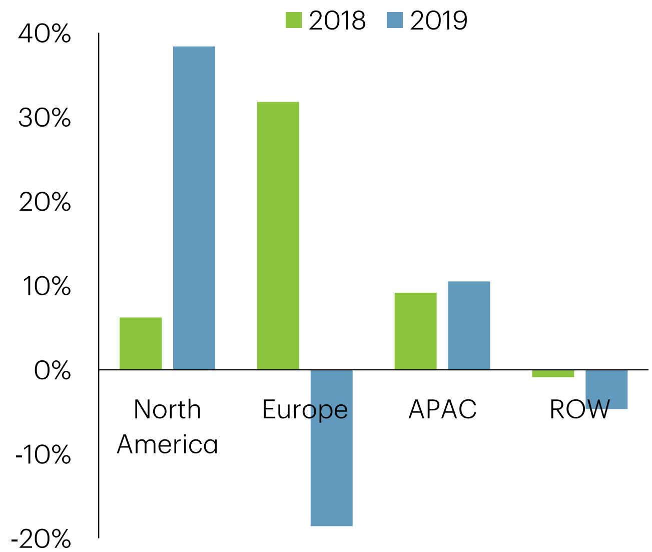


Source: OECD.org. As at Dec 31, 2019.

This economic strength for North America led to the largest year-over-year increase in infrastructure investment globally.

According to Inframation News, North American deal activity increased 38% with US$176 billion of transactions as compared to the rest of global investment which was down 9% year over year, driven by European investment which was down 20% in 2019.

Figure 24 - Year over Year Percent Change in Infrastructure Investment



Source: Inframation News. As at Dec 31, 2019.

The Global Opportunity

The global geopolitical environment is continuing to evolve, and we believe managers that have the ability to invest capital in the regions with the best risk-adjusted returns will be able to build resilient portfolios for their clients.

The opportunity set of global transactions creates opportunities to compare similar transactions and assets across borders, and take into account macro-economic environments and trends that will affect these assets over their lives. A manager with a global mandate will be able to bring important diversification to any infrastructure allocation.

"We believe active management will play a critical role to **preserve capital** and **grow multi-generational income streams over the long term.**

Contact us to find out how TDAM can bring new thinking to your most important challenges.

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