

## The Future is Back

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In the long shadow of the most recent global pandemic and in the face of an ongoing cyclical downturn, the Canadian press has become addicted to the narrative that there's no future for Canadian commercial real estate, at least not one that involves anything other than a long spiral of decline. Some have followed the press into this black hole of negativity, including investors, rating agencies and regulators.

In my experience, we generally need to go back in time to understand what's happening in the present and what's most likely to happen in the future. This is certainly the case with Canadian commercial real estate. History's not a perfect guide, but it's one we shouldn't ignore.

### **I. RECENT HISTORY OF CANADIAN COMMERCIAL REAL ESTATE**

I divide the history of Canadian commercial real estate, as I've experienced it over nearly 40 years, into four phases: (i) the 1980s boom; (ii) the 1990s collapse and reconstruction; (iii) the first two decades of this century and (iv) the disruption of the last four years. The fourth phase hasn't fully played out yet.

#### **1. THE 1980S BOOM**

Though the 1980s were expansive and flamboyant, I don't have to spend a lot of time on that decade. From a real estate perspective, it was an era of exuberant expansion fuelled by excessive debt. When a sharp decline in demand coincided with oversupply in the late 1980s, most commercial real estate organizations collapsed under the weight of their debt. Indeed, it's not an exaggeration to say that the Canadian real estate industry collapsed in the immediate aftermath of the 1980s.

#### **2. THE 1990S COLLAPSE AND RECONSTRUCTION**

The 1990s were excruciating and instructive. The mantra that emerged in the early part of the era was "survive to '95". It proved prescient, and by the mid-1990s commercial real estate markets began to re-liquidate, creating extraordinary opportunity for those able to overcome the residual trauma of the collapse.

In the latter half of the 1990s, Canadian pension funds began to play a leading role in the reconstruction of the industry. Public real estate entities also began to play a leading role, initially as aggregators but ultimately as operators and developers. Private real estate entities continued to play an important role across the spectrum of activity. These three groups essentially put the Canadian real estate industry back on a sustainable footing. Not surprisingly, they were careful about using debt. The reconstruction of the industry was achieved with equity... and intense operational focus. Two mutually reinforcing trends emerged in the late 1990s. One was encouraging growth on existing urban infrastructure rather than creating new infrastructure on an ever-widening perimeter, often referred to as “smart growth”. The other arose from the fact that millennials and their parents were beginning to exhibit a strong preference for living, working, learning and playing in the urban core. The combined impact of these two trends had profound impact on commercial real estate in the decades to follow.

### **3. THE FIRST TWO DECADES OF THIS CENTURY**

The reconstruction of the Canadian commercial real estate industry gained momentum in this era. Pension funds allocated ever more capital to commercial real estate, public real estate entities earned access to large amounts of low-cost equity and debt from the public capital markets and private real estate entities earned access to institutional capital on favourable terms that rewarded performance. In each case, access to capital was accompanied by greater accountability to the sources of capital.

In large measure because of the success of the reconstruction, the industry didn't miss a beat during the global financial crisis of 2008-2009. No ownership group had excessive debt, with the result that managing through the temporary disruption was relatively easy for the industry. In the end, rental rates and values held up across Canada. By the second half of 2009, the industry continued where it left off in 2008 and entered a period of extraordinary expansion and evolution.

The true success of the reconstruction enabled the industry to contribute to, and participate in, what I believe is the dominant secular trend in this century, urban intensification. If there was ever any doubt, the last three decades demonstrated that the city is the dominant form of human organization on our planet. The city is where everything that constitutes human culture receives its most intense, diverse and consequential expression.

Urban intensification forced the industry to adopt a more humanistic approach to developing and operating commercial space. Industry leaders began to see space from the vantage point of people who use it as well as people who invest in it. They began to see space as optimal light and air, a flexible and open floorplan and a collaborative rather than feudal relationship between owner-operator and user. They began to see space as a product of aesthetic as well as technical design. Finally, they began to see space as part of a large, amenity-rich, urban ecosystem rather than as an instance of the monumental isolation that characterized the office towers and enclosed shopping malls of the 1970s and 1980s. This was a big evolutionary step!

### **4. THE DISRUPTION OF THE LAST FOUR YEARS**

The human toll of the global pandemic that started in 2020 was severe and inequitable. The consequent economic disruption was global in scope, though governments around the world were able to intervene effectively without raising the spectre of moral hazard. Canadian commercial real estate was impacted immediately, but without liquidity challenges, due in large part to the balance-sheet and operating strength of ownership groups.

The human toll of recent geopolitical turmoil and the cyclical downturn that started in 2022 has also been severe and inequitable. The cyclical downturn manifested itself when central banks began responding to intense inflationary pressures worldwide by raising interest rates rapidly and dramatically, with impact on many sectors, including of course commercial real estate.

## II. CANADIAN COMMERCIAL REAL ESTATE TODAY

The rapid escalation in interest rates has put owner-operators of commercial real estate under pressure. While significant, this pressure is not an existential threat. Having remembered the lessons of collapse and reconstruction in the early 1990s, most owner-operators have manageable amounts of debt and the right kind of debt—fixed-rate, long-term, full-recourse loans matched to long-term, income-producing assets. Major owner-operators with strong covenants have real optionality in refinancing loans as they come due, and most of them are coming due down the road, not today.

Operating fundamentals have deteriorated and continue to be challenging, especially in the office sector. This separated the “haves” from the “have-nots”, with those focused on distinctive urban office space in mixed-use, amenity-rich neighbourhoods being among the haves. Indeed, all major owners of urban office space in Canada’s major cities are among the haves. All have strong balance sheets and highly developed operating capability. All will emerge stronger in the years to come.

What’s happening in Canada today is not what happened in the first half of the 1990s. Major owner-operators are not collapsing under the weight of their debt. They’re not even buckling. Unlike the early 1990s, values are not being undermined by lenders rushing to repossess and sell assets that secure their loans. There’s no glut of commercial real estate on the market, especially in the urban centres. Trading is orderly, with the result that values are holding for the most part.

## III. THE FUTURE IS BACK

There is, of course, always a future for large-scale human activities like Canadian commercial real estate. The future can range from bright to bleak, but it’s always there, whether we understand it or not. What interests me is that the recent view in North America is that the future for commercial real estate is so bleak that it effectively doesn’t exist. While this isn’t and can’t be the case, it’s how many are talking. Consider the “urban doom loop”. It goes like this. In response to the global pandemic, people flee the cities. As a result, demand for urban housing and urban commercial real estate declines precipitously, ultimately putting material downward pressure on the municipal tax base, which in turn erodes municipal services and intensifies all forms of urban malaise, especially crime, all of which induces more people to flee the cities, and on and on in a continuous downward spiral. This just hasn’t happened. Indeed, it appears that the opposite is happening in Canada’s major cities. They continue to grow in response to all forms of real estate need.

When all is said and done, it’s not what people say that matters, it’s what they do. Most of the behaviour I’ve observed in the past three years suggests that Canadians remain committed to the city as the principal venue for living, working, learning and playing. Demand for urban accommodation has not declined, but rather accelerated, putting upward pressure on prices and rental rates. Demand for urban office space did not collapse, though the supply-demand dynamic currently favours users and has put some downward pressure on net-effective rental rates, especially for commoditized office space. Demand for urban retail space is as strong as ever, if not stronger than ever. **The streets are busy with all types of real estate users!**

Canadians are committing to the city as much or more than ever. The city continues to be where everything that constitutes human culture receives its most intense, diverse and consequential expression. Challenges persist, of course, and the Canadian press will continue to wallow in negativity until well after the market has turned. Despite this, interest and belief in the future is growing. Not everyone is willing to accept positive views of the future, especially as it relates to commercial real estate, but many are more interested in evaluating them today than they have been since early 2020. In that sense, the future is back.

For leaders in commercial real estate, the future never left. Leadership decisions in the present must be informed by a vision of the future... not to mention comprehension of the past. Commercial real estate is a long game, not a short one, a marathon, not a sprint. It's an evolving response to fundamental and enduring elements of human need with a discernable and bright future in Canada.

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This commentary contains forward-looking information, including statements about (i) the possible evolution of Canadian commercial real estate and (ii) the possible acceleration of secular trends in Canadian commercial real estate. Although the forward-looking information is based on what the writer in his capacity as Founder & Executive Chair of Allied believes are reasonable assumptions, there can be no assurance that this information will prove to be accurate. This commentary reflects perspectives and beliefs as of May 24, 2024, and Allied undertakes no obligation to update forward-looking information, except as required by law. Allied cautions the reader not to place undue reliance on this information.