

ALLIED

My Thesis

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My thesis is simple and can be expressed succinctly as follows: the global pandemic of 2020-2021 will benefit the commercial real estate industry by accelerating three established secular trends—(i) urban intensification, (ii) humanistic operation and (iii) stress-tested leadership. Put even more succinctly, the pandemic will add significant impetus to city building. To say that my thesis runs contrary to the views of many is an understatement. That alone should make it interesting.

To be clear, I can't prove my thesis. Only human behaviour over time will do that...or not. What I can do is articulate the historical basis for predicting what I believe will happen. History's a good guide, though not a perfect one.

I. RECENT HISTORY OF CANADIAN COMMERCIAL REAL ESTATE

I'd divide the history of Canadian commercial real estate, as I've experienced it, into four phases: (i) the 1980s boom; (ii) the 1990s collapse and reconstruction; (iii) the first two decades of the 21st century and (iv) the global pandemic. The last phase is for discussion purposes only. As time passes, the global pandemic will prove to be a transitory period of disruption, much like the global financial crisis of 2008-2009. We'll remember it, but more as a temporal affliction than as a defining era. The first three phases are, in my opinion, defining eras or, at the very least, significant portions of defining eras.

1. THE 1980s

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 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 THE 21ST 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 two decades demonstrated that the city is the dominant form of human organization on our planet. (In the view of some, our world isn't a collection of regions or countries, but rather a collection of cities. This might be an extreme view, but there's something to it.)

The city is where everything that constitutes human culture receives its most intense, diverse and consequential expression. This is not to suggest that rural areas are inconsequential. Indeed, I believe rural areas are critical to human life and planetary survival, so we have to understand and protect them at all costs. A big part of doing so, in my opinion, is understanding and addressing climate change at a national and international level. That's another subject, but not one the commercial real estate industry can ignore. The city and the country are more interdependent than ever before.

Canadian cities experienced significant immigration and reverse migration from the suburbs in the last two decades, bringing more people and businesses into the urban core. Put simply, people were attracted by the richness and diversity of urban life, and businesses were attracted by the burgeoning concentrations of human talent. This did not hollow out the inner or outer suburbs, as they continued to grow meaningfully; it simply changed the direction of movement from predominantly outward to meaningfully inward. Urban intensification was a clear response to this change in direction.

Urban intensification is essentially compressing more people into a confined area on a 24-7 basis. This ultimately 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 rather than 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 and user. They began to see space as a product of aesthetic and 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.

Real estate is no longer a passive investment or a static tolling business. It's a profoundly human business that needs to keep pace with demographic and technological change, as well as ongoing change in human attitudes and values. That means we have to run commercial real estate to save the global environment, not destroy it. It means we have to foster human wellness, not undermine it. It means we have to promote diversity, not impose uniformity. It means we have to facilitate creativity, not encourage conformity. Finally, it means we have to build and operate as city builders, which in a way embraces everything else I've just said. City builders see commercial real estate as an integral part of a much larger ecosystem of infrastructure, buildings and human beings.

To put all this into contemporary perspective, Canadian commercial real estate in this century is evolving in a way that makes ESG (environmental, social and governance) practices and EDI (equity, diversity and inclusion) practices of paramount importance. Working toward best practices in ESG and EDI is now a matter of enlightened self interest. No organization is yet where it wants to be, but no organization will remain competitive if it doesn't work sincerely and assiduously toward getting there.

4. THE GLOBAL PANDEMIC

The human toll of the pandemic 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. Property trading came to a grinding halt, much as it did during the global financial crisis, but there was no grave financial distress, despite temporary downward pressure on rental revenues. When trading resumed, it did so at pre-pandemic price levels or higher, especially for high-quality urban real estate.

Early on in the initial shut-down phase of the pandemic, speculation about the future of real estate was rampant. Many thought urban housing values in Canada were going to collapse as people fled the cities. Exactly the opposite happened in most major and satellite cities. Many thought Canadian chartered banks were going to contract as a result of the consequent economic disruption. Again exactly the opposite happened. Many thought people were going to work gleefully and productively from home on a permanent basis. We're now at a point where protracted working from home is giving rise to reversal or outright backlash on the part of employers and employees alike. Many thought people were never going to shop at physical stores again but rather would procure their entire spectrum of needs and wants online. We're now at a point where people are literally lining up to get into stores that are reopening after a second shut-down phase.

Speculation is great fun and can be intermittently profitable for those who aren't left holding the bag when the frenzy ends. But in the real world of commercial real estate, we have to make longer-term decisions and predictions based on what people actually do, not on what they say they might do. While the pandemic is not yet over, it appears that people are going to keep doing what they did pre-pandemic rather than fundamentally altering either their basic nature or their established way of life. This really shouldn't come as a big surprise, especially if you look at human history over the past few millennia.

II. THE FUTURE OF CANADIAN COMMERCIAL REAL ESTATE

This brings me back to my thesis.

Most of the behaviour I observed in 2020 and thus far in 2021 suggests that Canadians remain committed to the city as the principal venue for living, working and playing. Demand for urban accommodation has not declined, but rather accelerated, putting upward pressure on prices. Demand for urban office space has not collapsed, but rather remained strong, putting continued upward pressure on rental rates in Montréal, Toronto and Vancouver. Despite the fact that urban retail users have borne the economic brunt of the pandemic, many are committing to the few strong urban locations that come available, effectively looking right through the pandemic to a strong rebound. People are betting on, and committing to, the city more than ever, perhaps in part because the pandemic made us aware of how much we cherish the rich and varied attributes of urban life and how much we took them for granted until we were sent *en masse* into domestic isolation for a protracted period of time. Far from reversing urban intensification, the pandemic seems more likely to have the long-term effect of accelerating it.

There's no doubt that the pandemic heightened the importance attributed to ESG and EDI by people generally and by investors in particular. Long before the pandemic, investors observed a positive correlation between good financial performance on the part of public entities and a broader recognition of social responsibility. Large institutional investors began allocating capital accordingly, ultimately with a view to achieving better returns. This effectively put pressure on public entities to submit to informed scrutiny with respect to social responsibility. As the pandemic unfolded, institutional focus on ESG and EDI increased, perhaps because the importance of wellness, resilience and sustainability was highlighted in a truly global context. At its most fundamental level, the pandemic elicited a comprehensive humanistic response and illustrated the importance of humanism and social responsibility to our survival as a species.

There's also no doubt that the pandemic stress-tested the next generation of leadership in Canadian commercial real estate. The current generation was stress-tested in the 1990s and was instrumental in reconstructing the industry. This founding generation is now giving way to its successor generation. While the successors are accomplished and well prepared, most matured in an era of uninterrupted growth and prosperity. Crisis management is not something that can be learned independently of experience, and you just don't experience it in an era of continuous growth and prosperity. Because of the pandemic, the next generation of leaders has now been crisis-conditioned in a meaningful way, and that's another good thing for the industry.

To summarize, my thesis is based on how I expect future evolution in Canadian commercial real estate to flow from past evolution. Commercial real estate is not static; it's wholly dynamic, like all other business activities. My job in the last three decades has been to anticipate how commercial real estate will evolve in Canadian cities. My job today is to anticipate how it will evolve going forward. In light of past human behaviour, I can't help but believe the global pandemic of 2020-2021 will benefit the commercial real estate industry by accelerating three secular trends—(i) urban intensification, (ii) humanistic operation and (iii) stress-tested leadership. I look forward to learning more as this plays out, and I have no doubt there will be surprise along the way. Surprise brings challenge, but more often than not, it also brings opportunity.

April 5, 2021

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 President & Chief Executive Officer of Allied believes are reasonable assumptions, including continued re-opening of Canada's cities over the remainder of 2021, there can be no assurance that this information will prove to be accurate. Material areas of uncertainty include the fact that no person or entity can predict with certainty how office users and consumers will respond once authorities lift or relax physical-distancing measures across Canada. This commentary reflects perspectives and beliefs as of April 5, 2021, 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.