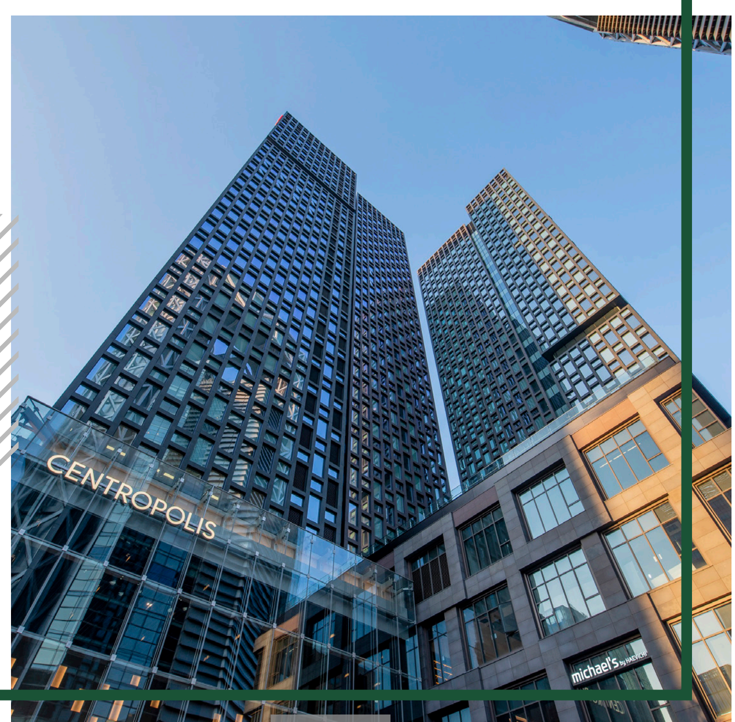
TD Global Investment Solutions

Real Assets Market Report 30 Minutes

Real Assets Market Report

Summer Edition 2024



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Investment Outlook

Canadian commercial mortgages continue to provide accretive income while insulating investor returns from the increased volatility in interest rates.

Within private debt, high credit quality and global diversification provides an income ballast in an uncertain economic environment. Incremental income and potential capital appreciation from interest rate moderation provide upside.

We believe a significant portion of the value adjustments in the Canadian commercial real estate space have been taken. Moving forward, we see more reason for confidence in the multi-unit residential, retail and industrial spaces. Globally, we believe the majority of the value adjustments have occurred in the U.S., U.K. and Nordic countries, while other regions, such as Australia, are in the midst of value adjustments.

Within global Infrastructure, increases in cash flow from higher-than-expected inflation is buffering rising interest rates. Investor appetite remains strong, particularly for energy transition investments and critical infrastructure sectors that generate stable, growing cash flows.

Outlook

Canadian Commercial Mortgages

The financial market started the year forecasting 4-6 rate cuts, which now might seem to be overly eager. Inflation and economic indicators continue to support the higher for longer scenario with fewer cuts forecasted. Bond yields continue to rise across the entire spectrum following the fall in the latter half of 2023 (Figure 1) and continue to attract new allocations to fixed income asset classes, including commercial mortgages.

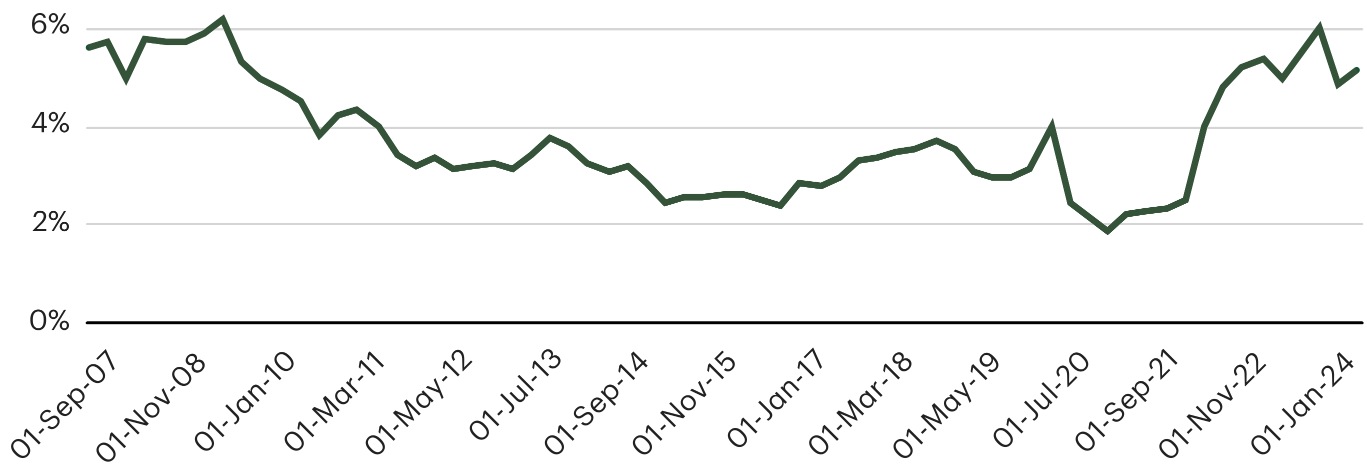
Figure 1: Five Year Government of Canada Yield

Source: Bloomberg Finance L.P., as of Mar 29, 2024.

In Figure 2, we observe the 5-year commercial mortgage rate to be around 5.3% and near its highest level. It has followed a similar pattern as the GoC bond yield by peaking in the latter half of 2023.

Figure 2: Canadian Commercial Mortgage Rates

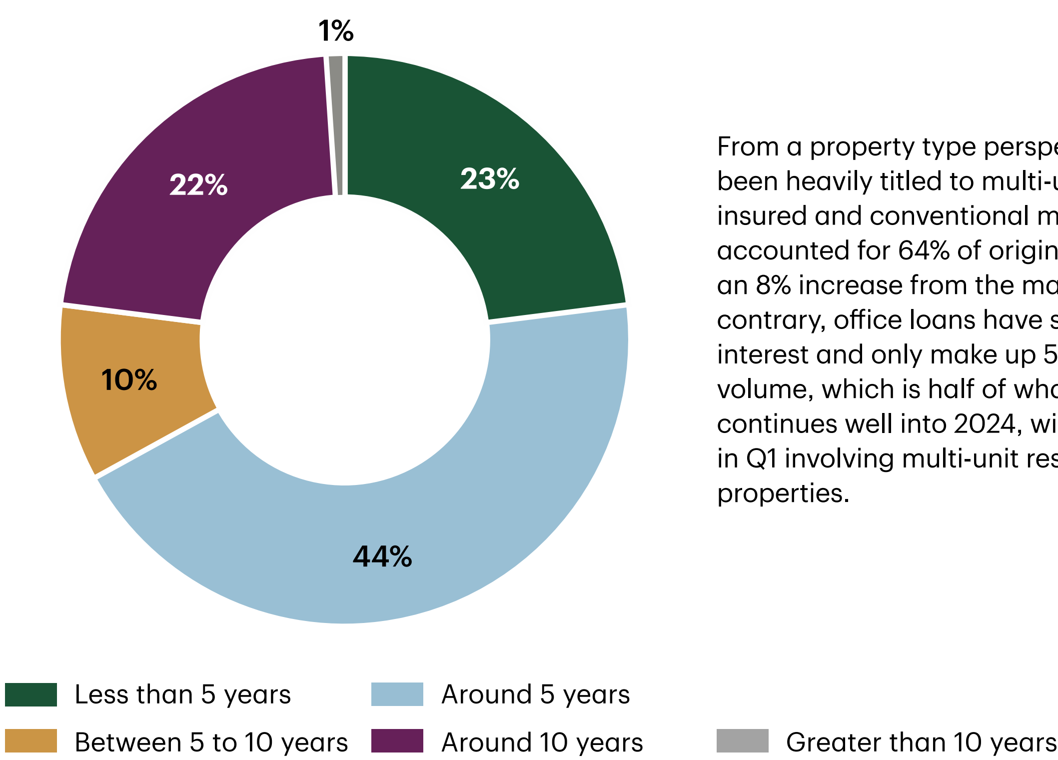
Source: RBC Capital Markets. As of Mar 31, 2024.



The Canadian commercial mortgages market experienced continued growth in 2023. The originations in 2023 were heavily skewed towards loan terms of 5 years or shorter. Generally, borrowers remained hesitant to lock-in longer terms despite capital availability from lenders. This mismatch has continued into the first quarter of 2024 and is expected to continue as borrowers are looking for rates to come down before committing to longer terms.

Figure 3: Canadian Mortgage Origination by Term

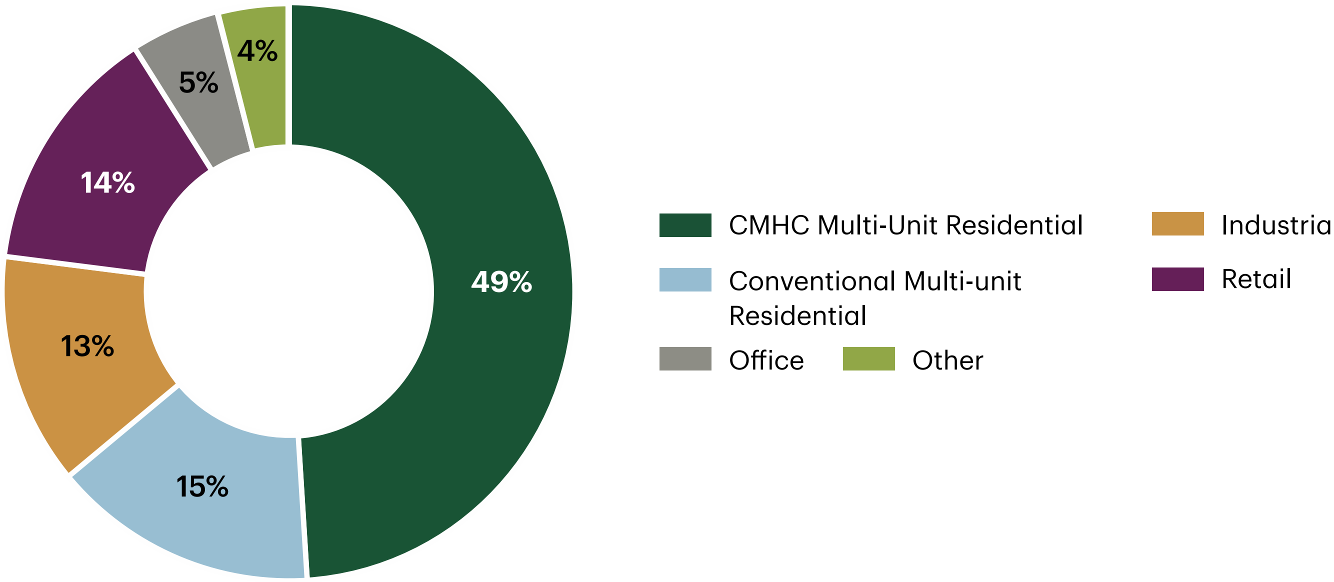
Source: Intellifi. As of Dec 31, 2023.



From a property type perspective, origination has been heavily titled to multi-unit residential: the total of insured and conventional multi-unit residential loans accounted for 64% of originations in 2023, which is an 8% increase from the market share in 2022. On the contrary, office loans have seen a decline in lender interest and only make up 5% of the total origination volume, which is half of what it was in 2022. This trend continues well into 2024, with over half of new deals in Q1 involving multi-unit residential and industrial properties.

Figure 4: Mortgage Origination by Property Type

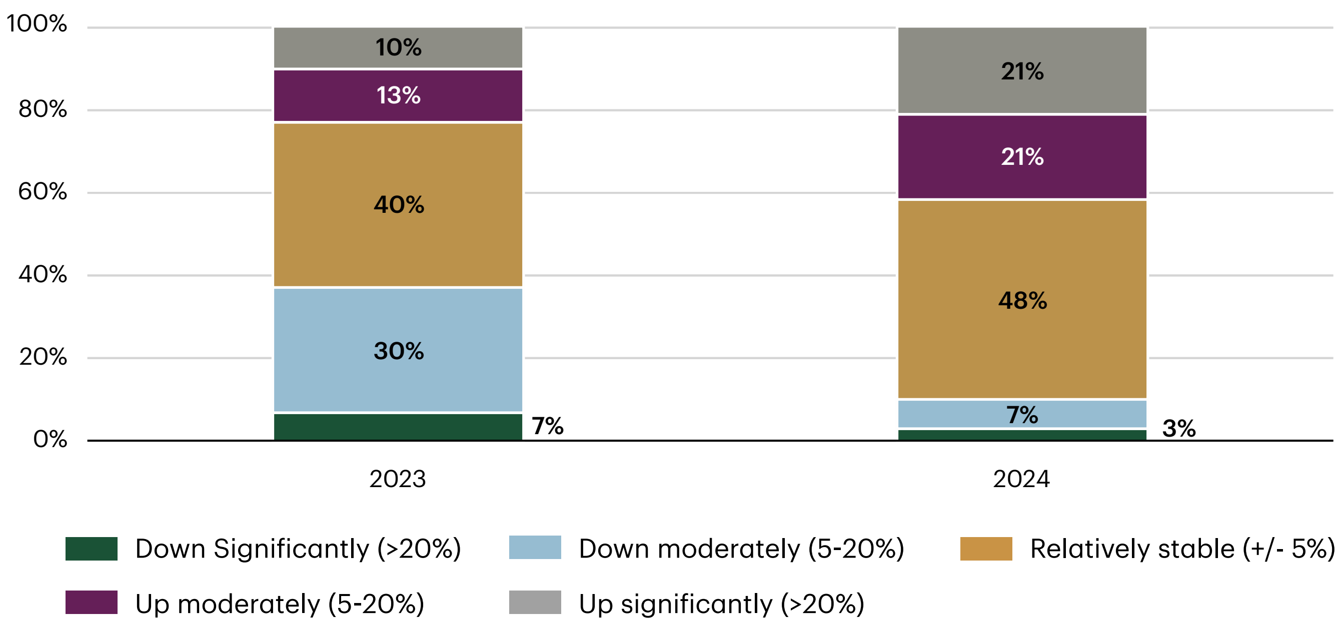
Source: Intellifi. As of Dec 31, 2023.



Looking forward, based on the lender sentiment survey by Intellifi (as shown in Figure 5), 42% of lenders surveyed reported an increase to their origination budget. This is a notable increase compared to last year where it was only 23% of respondents. Conversely 10% are reporting a likely decrease, which is down significantly from 37% last year. The results overall demonstrate lenders optimism with higher capital availability for deployment. As such, mortgage strategies with the ability to source top-quality opportunities through relationships and flexibility to customize solutions for borrowers are more likely to achieve best execution for investors.

Figure 5: Lender Sentiment Survey (relative to origination budget)

Source: Intellifi. As of Mar 31, 2024.



Private Debt

The long-awaited interest rate easing that occurred toward the end of 2023 did not continue into the first quarter of 2024. Despite sentiment favoring stable or easing interest rates, continued strong economic and inflation data saw expectations of central bank easing pushed out as recession fears further subsided. Sovereign rate curves rose moderately across G7 economies, while credit spreads narrowed to reflect the strong economic backdrop. Slightly higher all-in interest costs meant issuers were present but selective in Q1 – activity was strong in short- and mid-term tenors, still tepid in the longer end of curves. Private debt yield levels ended Q1 in the 5.25 - 5.75% range, higher than 2023 year-end but still lower than the peaks of 2023. Forward market views are cautiously strong.

Private Debt

Investment Grade Private Debt Market

Over the first quarter of 2024, investment grade credit spreads in Canada tightened considerably in the short and middle of the curve. U.S. and U.K. corporate spread movement was more mixed but fell slightly in aggregate. This tightening only partly offset sovereign rate increases, meaning nominally negative fixed-income returns and modestly higher all-in yield levels across the mid- and longer-duration part of yield curves. As is illustrated in Figure 6 below, credit spreads where lending strategies typically have exposure (U.S., U.K., EUR, AUD) saw modest tightening. The same dynamic is shown in the Canadian sovereign rate curve in Figure 7.

Figure 6: U.S. Corporate BBB Spread

Source: Bloomberg L.P. As of March 28, 2024.

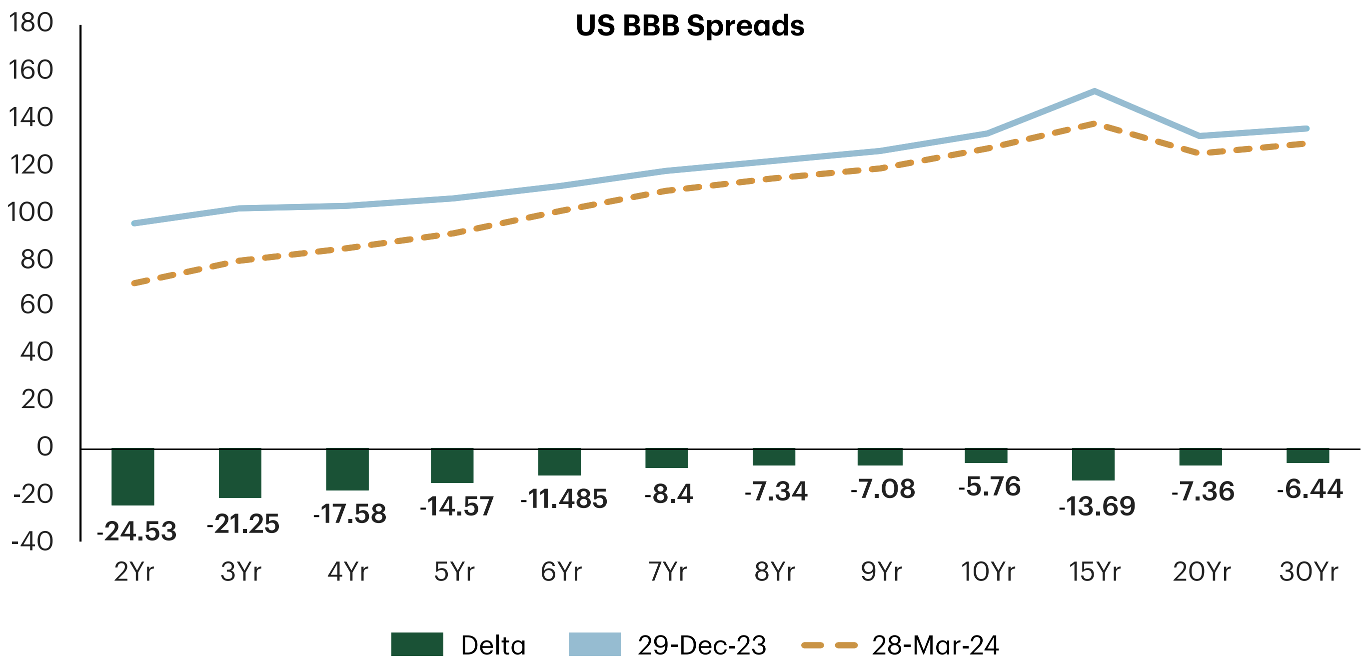
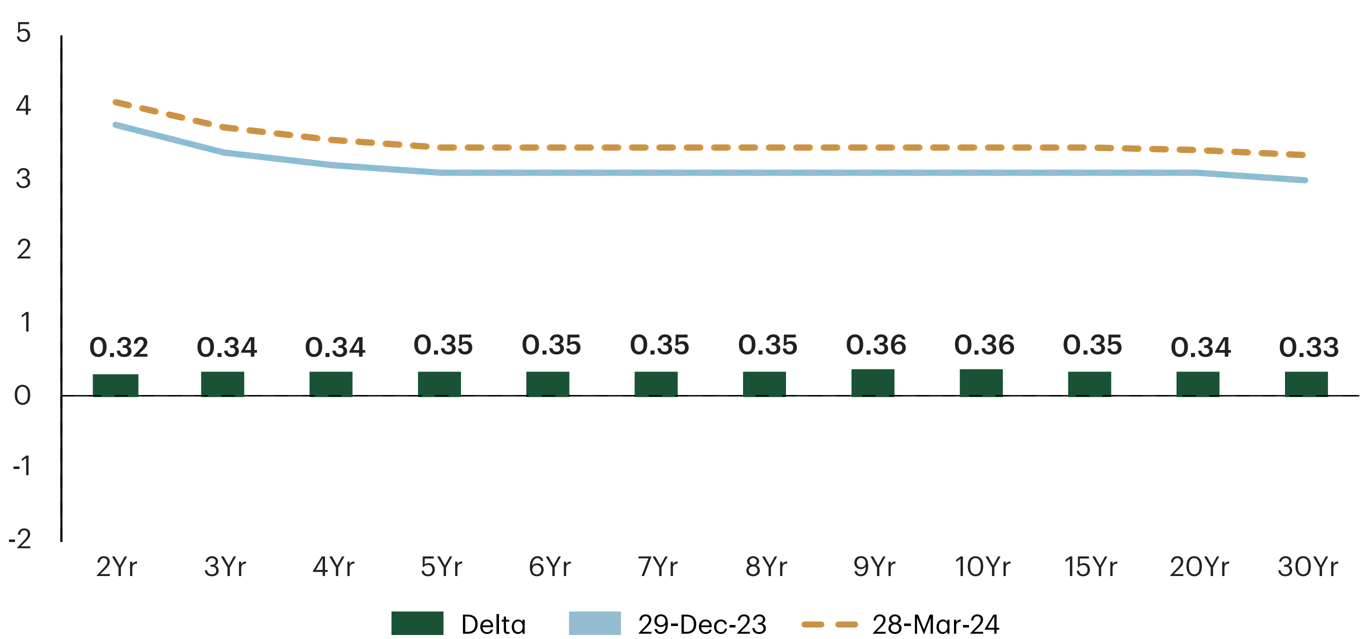


Figure 7: Canadian Sovereign Curve

Source: Bloomberg L.P. As of March 28, 2024.



Key Sector Trends

Power & Energy (Renewables)

In Canadian power sectors, new awards for power purchase agreements in BC, Alberta, Ontario and Quebec offer contracted financing opportunities going forward. U.S. Inflation Reduction Act Tax Credits are fueling new renewables development by project sponsors. Cumulative interest rate increases continue to dampen the project portfolio merger and acquisition market as participants continue to incorporate valuation and leverage cost realities. Lenders must be vigilant when taking construction risk in an environment of continued inflationary pressures.

Infrastructure

A promising future pipeline of Canadian infrastructure projects exists from mid-2024 onwards, assuming governments can achieve budgeted affordability levels. There are attractive opportunities in smaller, niche projects where direct relationships can allow for a swifter adjustment to project cost increases. Strong appetite for infrastructure debt from life insurance companies continues to cap value creation opportunities, particularly on longer-term projects. Again, lenders must remain vigilant when taking construction risk in an inflationary environment.

Private Corporate

Borrowers are accessing the market aggressively as recent stability in medium-term rates drive strong issuance. Corporate spread tightening is reducing value creation opportunities with deals closing with buyer oversubscription on plain vanilla corporate structures.

Real Estate

After interest rate increases slowed transaction opportunities, buyers and sellers have continued their adjustment to valuation differentials, coming to market with somewhat aggressive structures. There is value in focusing on multi-residential and industrial opportunities given the uncertain backdrop of re-leasing dynamics in select office and retail markets.

Trends

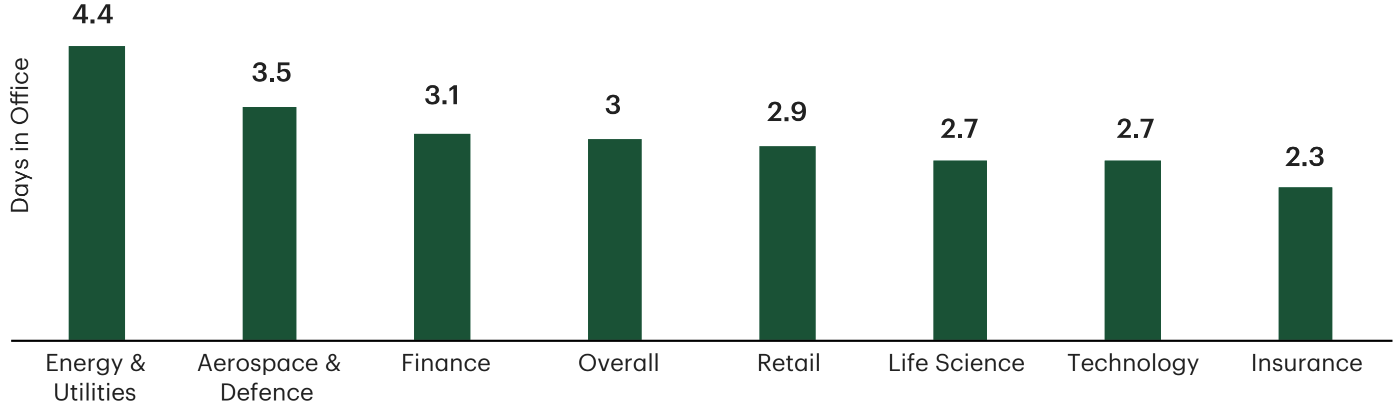
Global Commercial Real Estate (Canada and International)

Office

Across the globe, office utilization levels reveal improving and even stabilizing trends, with Asian cities leading the way in the return to office culture. This has garnered investors' interest with the Asia Pacific region recording a 13%[1] year-over-year growth in investment volume during the first quarter of 2024 with office remaining the most active sector.

Figure 8: Return to Office Policies for Fortune 100 companies.

Source: JLL Research, Canadian Commercial Real Estate Outlook 2024.



[1] JLL, Asia Pacific Capital Tracker, April 2024.

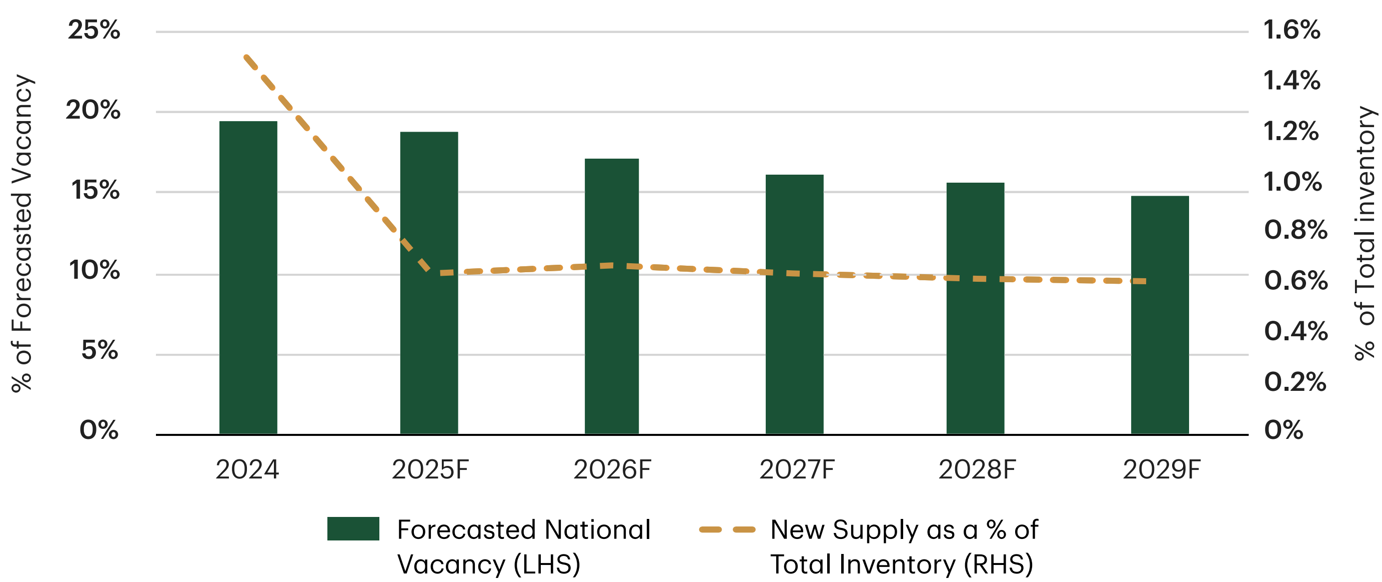
With most companies adopting return to office policies, tenants are demanding more from their office spaces in terms of quality, design, location, and sustainability, leading to a flight-to-quality where tenants seek out prime quality properties that align with their evolving needs. It is expected that older/vintage office assets, that are not transit linked and equipped with less amenities, will continue to struggle in the year ahead as demand for premium spaces remains high.

Challenges also loom on the horizon. In the U.S., the staggering $1.1 trillion of commercial real estate loans maturing in 2024-2025[2] coupled with a "higher-for-longer" rate environment could limit refinancing options and constrain landlords' ability to generate sufficient operating cash flows to meet lenders' stricter underwriting standards. Another area of concern remains in the decline of effective rents due to the rising concessions offered by landlords to incentivize prospective tenants. It is expected that rent compression will be more pronounced in 2024, with the largest declines in older and inferior assets.

However, amidst the challenges, several factors offer potential stabilizers for the office sector in 2024. One of them is the limited construction activity from developers because of the uncertainty in office demand compounded by higher labour costs and the higher cost of borrowing. This has brought a decline of over 50% from 2020[3] in office construction starts in Canada.

Figure 9: Limited Supply forecasted to stabilize vacancy in Canada

Source CBRE: CBRE Office Forecast Q1 2024.



Ultimately, if interest rates start to decline, this can offer companies clarity. The office sector stands at a crossroads, poised between challenges and opportunities. As the sector navigates through turbulent waters, landlords who are adaptable and hold quality/premium assets will be better equipped to weather the storm.

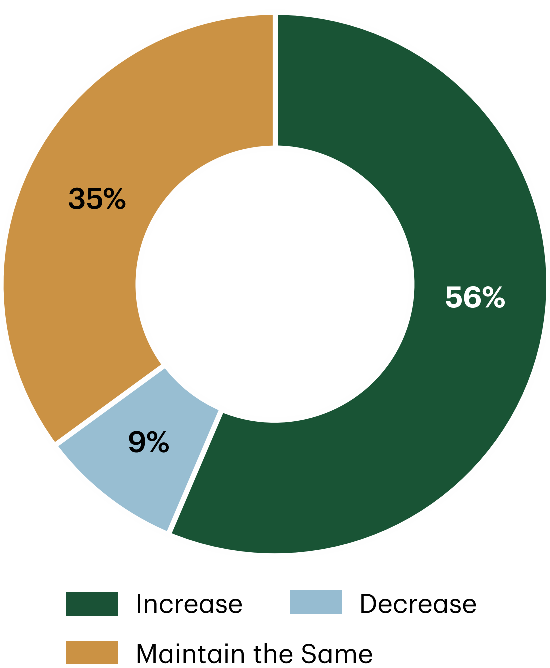
[2]TD Economics U.S Commercial Real Estate: Debt Maturity Risks Linger, Potential for More Distress Ahead.
[3]Colliers, National Market Snapshot, Q1 2024.

Retail

In Canada, the pandemic-induced fears of e-commerce largely overtaking the preferred method of shopping over physical stores has waned as e-commerce sales have normalized. This trend is also seen in the growing demand for physical retail spaces, especially with grocers and food and beverage retailers looking to grow their store count.[4] This illustrates the positive sentiment from industry stakeholders, primarily retail landlords, property managers, retailers, and commercial real estate brokers, in their leasing expectations for the year as shown in Figure 10.

Figure 10: Canadian Industry Stakeholders Expectations for Leasing Activity

Source: JLL Canada Retail Outlook Survey, February 2024.

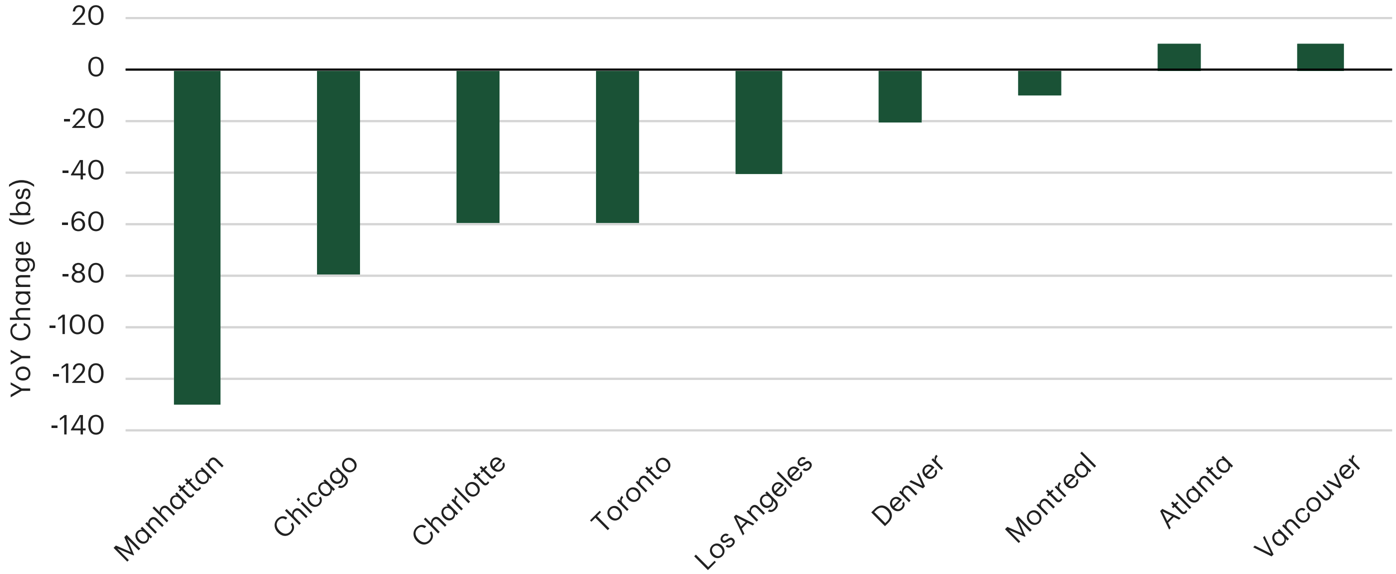


Leasing for retail space has remained strong to start the year and there aren't many available spaces left. For context, 35.1% of available space has been leased over the last 12 months, compared to 31.9% in Q1 2019.[5] The lion's share of this demand is coming from food and beverage tenants, particularly fast-food restaurants, discounter retailers and experiential tenants. With the limited available space, it is prompting retailers to secure leases quickly, which is allowing landlords to be picky about who they rent to. Figure 11 illustrates the decline in vacancy rates across major cities in the U.S. and Canada.

[5]JLL United States Retail Market Dynamics Q1 2024

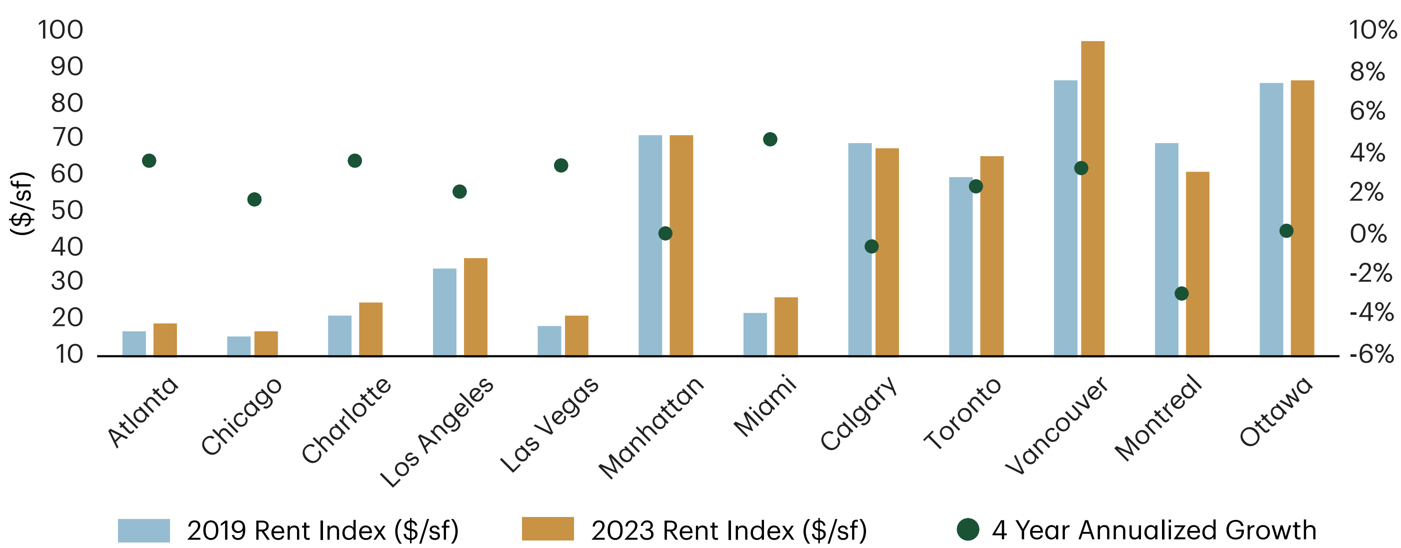
Figure 11: Year-over-year Change in Vacancy rates across North American Cities

Source: CBRE Econometric Advisors Q1 2024 Flash Report and CBRE Canada Historical Retail H2 2023.



However, some challenges do remain with outstanding credit card balances surpassing $1 trillion[6] in the U.S. This will likely have a drag on household finances in 2024 as rising interest rates will curtail discretionary retail purchases.[7] Additionally, while rents have been growing across different cities as shown in Figure 12 below, one area to monitor will be how lower consumer spending could impact retail rent growth, as consumer spending has typically shown a higher correlation with retail rents (above 95% post 2011).[8] As a result, retail rent growth may potentially remain muted for the year as consumers continue to feel the pinch of increased prices, depleted savings and rising interest rates.

Figure 12: Rental Growth Across North American Cities



Overall, Investors' outlook on the sector remains cautiously optimistic with the mix of opportunities and challenges. It remains a market where being nimble and careful can pay off, especially for investors who have experience in operating and developing retail assets and can leverage that experience to spot the right opportunities at the right time.

[6]Cushman Wakefield, 2024 U.S Macro outlook [7]Cushman Wakefield, 2024 U.S Macro outlook
[8]CBRE: Q1 2024 U.S. Retail Overview & Outlook

Industrial

Global availability rates continue to climb, particularly in North America, due to the higher supply delivered in 2023. Rents are increasing but at a decelerating pace.

Canada saw national availability rates rise again in Q1 2024, driven by higher new supply being delivered and negative net absorption. Rising from a near 40-year low of 1.6% in Q3 2022, the current national availability rate of 3.7% is at its highest level in almost six years.[9] However, the pace of its growth is starting to ease, slowing to a 50 bps quarter-over-quarter increase compared to the record-setting 70 bps increase in the previous quarter.[10] The first quarter was also the first time in nearly four years that net absorption turned negative, returning 350,000 square feet to market.[11] Every market in Canada saw their availability rates rise except for Edmonton amid no new supply. Halifax saw the highest jump in availability rates, spiking 400 bps year-over-year due to record breaking new supply getting delivered over the quarter and a slowdown in pre-leasing activity.[12]

National Canadian rental rates in Q1 2024 grew by a marginal 0.9% year-over-year to $16.06 per square foot, which is the smallest increase since early 2017.[13] Halifax saw the largest year-over-year growth in net asking rents due to a mass completion of new generation industrial spaces allowing the new listings to command higher asking net rental rents than product that had previously been on the market.[14]

[9]CBRE Data Views, Market Trends: Forecast
[10]CBRE Canada Industrial Figures, Q1 2024
[11]Ibid. [12]Ibid. [13]Ibid.
[14]Colliers, National Market Snapshot, Q1 2024.

Figure 13: Canadian Industrial Supply & Demand

Source: CBRE, Canada Industrial, Q1 2024.

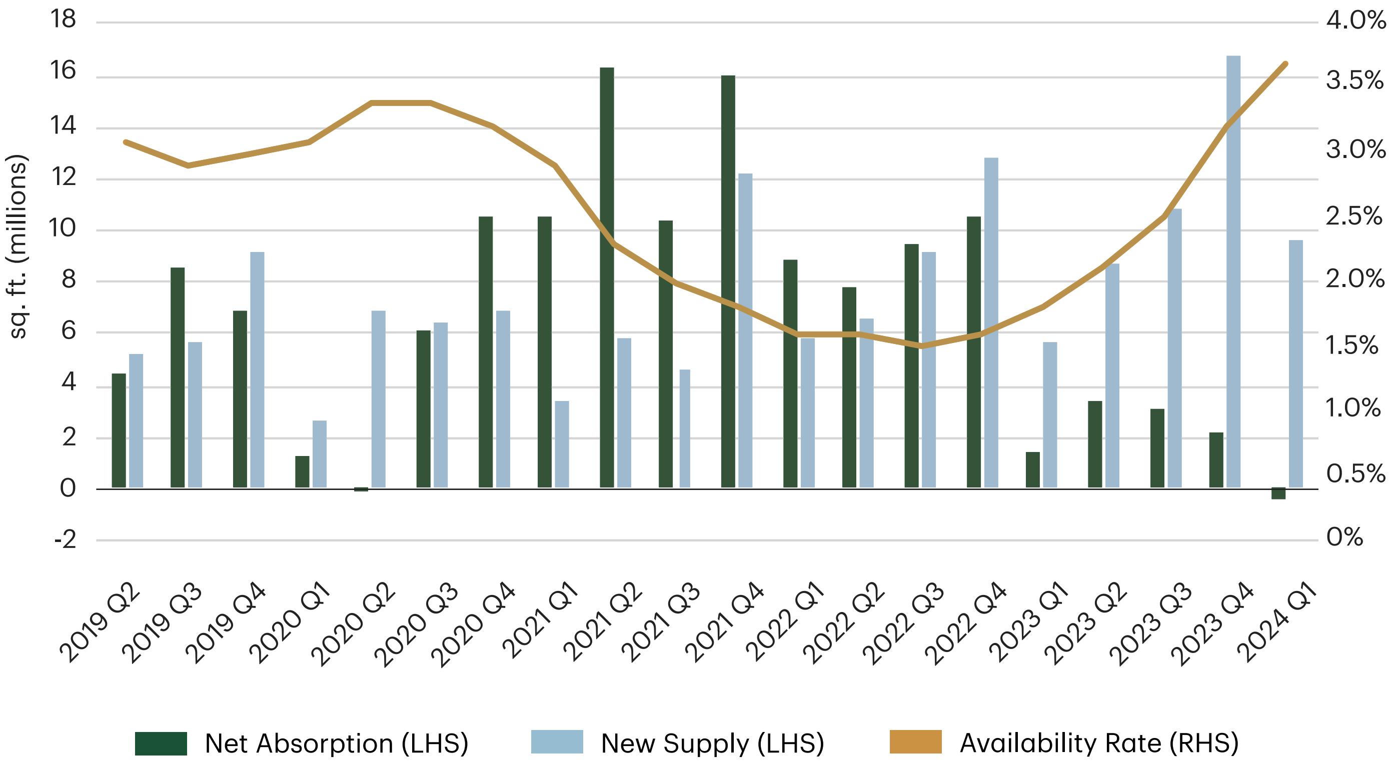
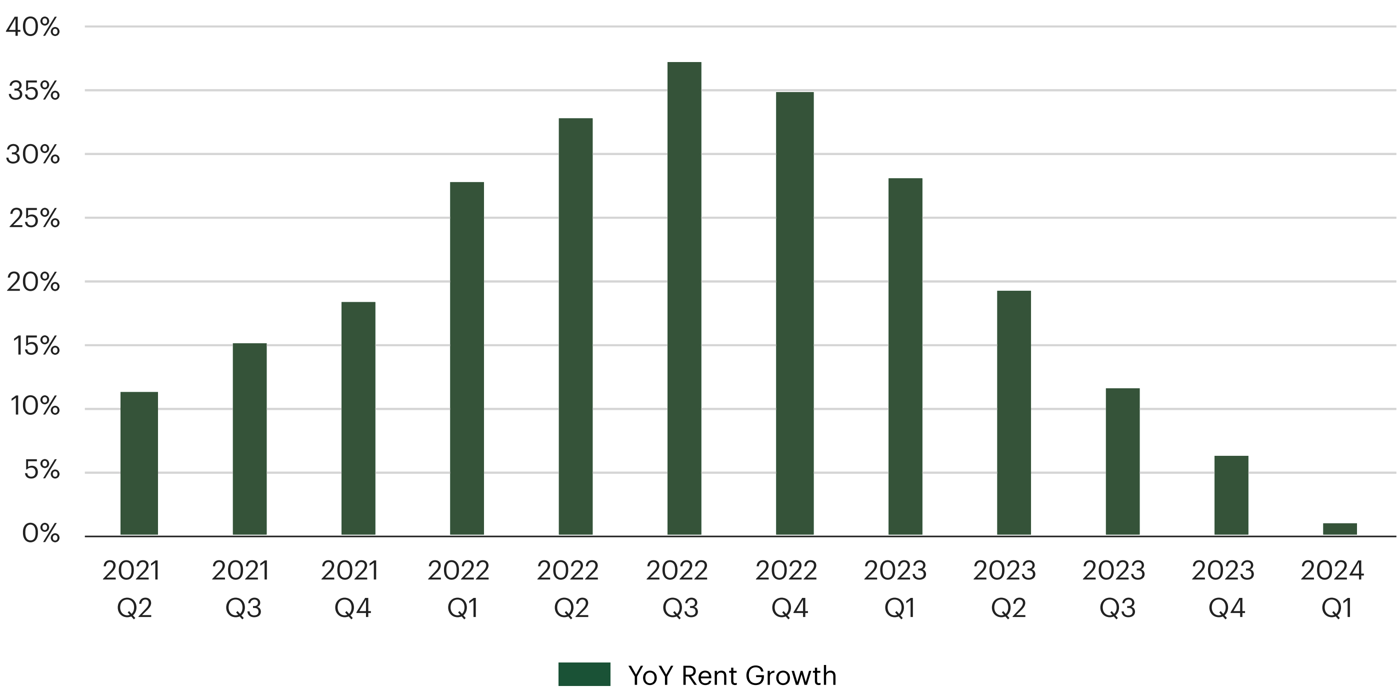


Figure 14: Net Asking Rent Growth in Canada

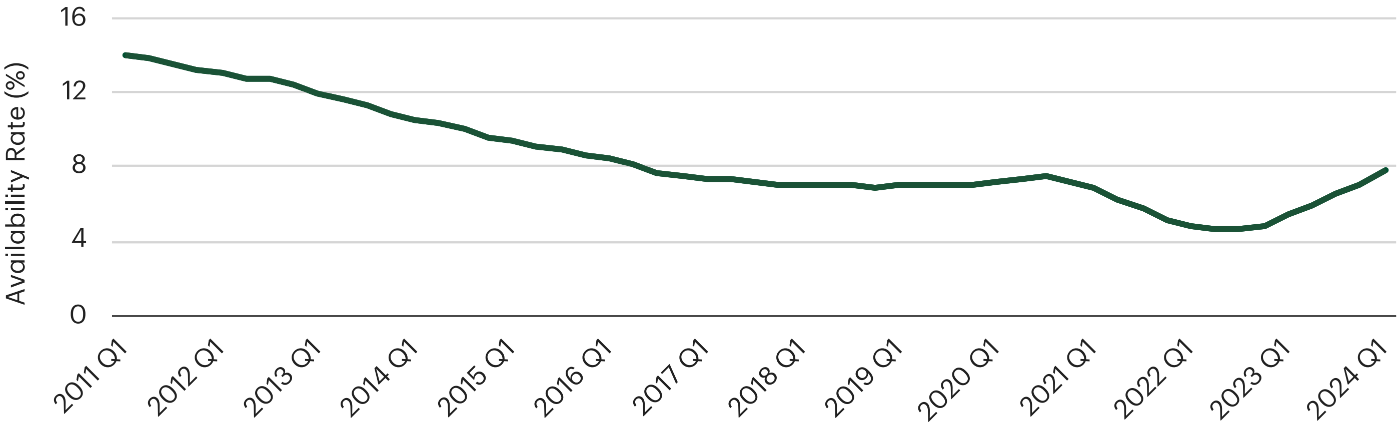
Source: CBRE, Canada Industrial, Q1 2024.



In the U.S., the rapid expansion of stock and a noticeable decrease in demand for existing space has driven up the national availability rate to 7.8% in Q1, up from 7.1% in the previous quarter.[15] Additionally, sublet availability has eclipsed 1%, a level not seen since the great financial crisis. Regionally, the major markets in the Sun Belt continue to experience the greatest increase in availability rates. [16]National availability rates are expected to continue an upward trend towards 9% by 2029 as annual leasing is not sufficient to cover new supply growth. The heightened supply is slowing rental growth, which only increased by 6.5% in Q4 2023, the lowest rate in more than two years.[17]

Figure 15: U.S. Industrial Availability Rate

Source: CBRE, U.S. Industrial Availability Index. As of Mar 31, 2024.



Leasing activity in Europe's logistics market in Q1 2024 has returned to pre-pandemic levels, with quarterly take-up declining by 19% year-over-year as demand continues to cool off from the records set in 2021 and 2022.[18] The leasing activity slowdown is due to longer negotiation periods and cost-sensitive tenants, which is slowing the flow of lease deals. Meanwhile, average vacancy rates rose for the fifth consecutive quarter but remain below their 10-year average.[19] Leasing preferences continue to target modern, energy efficient buildings given the cost concerns highlighted by tenants in addition to product with strong sustainability credentials. Rising vacancy rates have a spillover effect impacting rental growth, with the average prime rental growth softening to a 6.6% year-over-year increase in Q1 2024, down from 8.1% in the previous quarter.[20] Average rental growth has slowed for five consecutive quarters. Even given this trend in rental growth, the European logistics sector has witnessed higher rent growth compared to other property sectors offering favourable market conditions to landlords.[21]

In the Asia Pacific, net absorption fell from subdued sentiment and seasonal factors. Tier 1 cities saw a decrease in net absorption of 688,000 square meters (the lowest reading since 2019), comparted to 1.7 million in the previous quarter.[22] Landlords are finding it challenging to raise rent levels due to high vacancy rates and weaker demand. Regionally, Greater China is seeing the most pressure with quarterly rents declining again in Q1 2024. Comparatively, lower vacancy rates and steady demand in Australia pushed up rents higher in Sydney and Melbourne.[23]

[15]CBRE, US Industrial Availability Index, Q1 2024.
[16]Ibid.
[17]CBRE, US Quarterly Outlook, The Full Picture, March 2024.
[18]JLL, European Logistics Market Update, May 2024.
[19]Ibid.
[20]Ibid.
[21]Ibid.
[22]JLL, Asia Pacific Logistics and Industrial, Q1 2024. Tier 1 cities defined as Beijing, Shanghai, Hong Kong, Tokyo, Singapore, Seoul
[23]JLL, Asia Pacific Logistics and Industrial, Q1 2024

Multi-unit Residential

There is a long running undersupply of homes and chronic affordability challenges in many global housing markets that continue to underpin investment rationale for the residential sector. Investment activity is expected to grow through 2024 despite some investors still eagerly waiting for central banks to cut policy rates before fully executing new opportunities.

Within Canada, CMHC reported the lowest national vacancy rate since 1988, falling to 1.5% in 2023.[24] The primary drivers were a record population growth that is outpacing housing supply and high interest rates that are discouraging home ownership.[25] Growing demand and tight vacancy continue to push up rents, with the average rent of a 2-bedroom apartment climbing 9.2% year-over-year in 2023 and is expected to continue upwards by another 5.9% in 2024.[26] Declining tenant turnover rates are challenging landlords' ability to realize rental gains. The national turnover rate declined for a second consecutive year in 2023, dropping from 13.6% to 12.4%. Rents for units that were turned over grew by 24.1% year-over-year compared to 5.1% in units that did not turnover.[27]

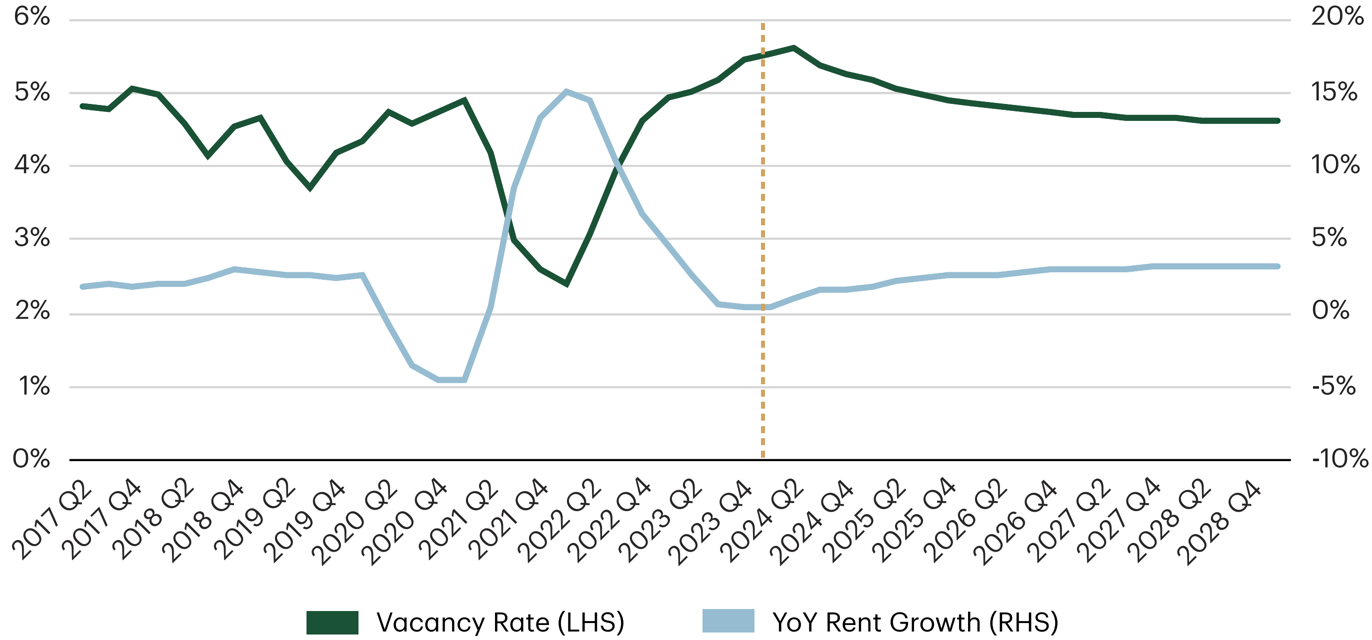
Multi-unit residential fundamentals in the U.S. continue to soften as new supply arrives to the market. There was a record level of completions in the second half of last year. More completions are expected to saturate the market in 2024 with deliveries increasing by 14% year-over-year.[28] In 2023, most completions were concentrated in the Sun Belt region.[29] Of the one million multifamily units currently under construction, 43% are concentrated in the south of the country.[30]

The U.S. national vacancy rate in Q1 increased to 5.5%. Regionally, markets in the Sun Belt that are flush with supply experienced negative year-over-year rent growth in Q1. Conversely the Northeast and Midwest of the country continued their trend of strong rent growth due to constraints on supply and positive net absorption.[31]

[24] JLL, Canadian Commercial Real Estate, 2024 Outlook
[25] Ibid.
[26] CBRE, Canada Real Estate Market Outlook, 2024
[27] Ibid.
[28] CBRE, US Quarterly Outlook, The Full Picture, March 2024
[29] Ibid.
[30] TD Economics, US Commercial Real Estate, February 2024
[31] Ibid.

Figure 16: U.S. Multi-Family Residential Forecast

Source: CBRE, Overview Q1 2024.



The U.K. remains a bright spot for residential real estate. The U.K.'s residential market is similar to Canada's in that most of the rental housing is supplied by private landlords. Institutional investment into purpose-built rental housing is attracting significant capital from global institutions. The U.K. market also continues to experience affordability challenges. The imbalance to supply and demand is the highest it has been in over 10 years, leading to outsized rental growth. In addition, London's strong population growth is driving demand for rentals. This is in addition to a large student population contributing to demand, with nearly a quarter of the international students studying in the U.K. being based in London.

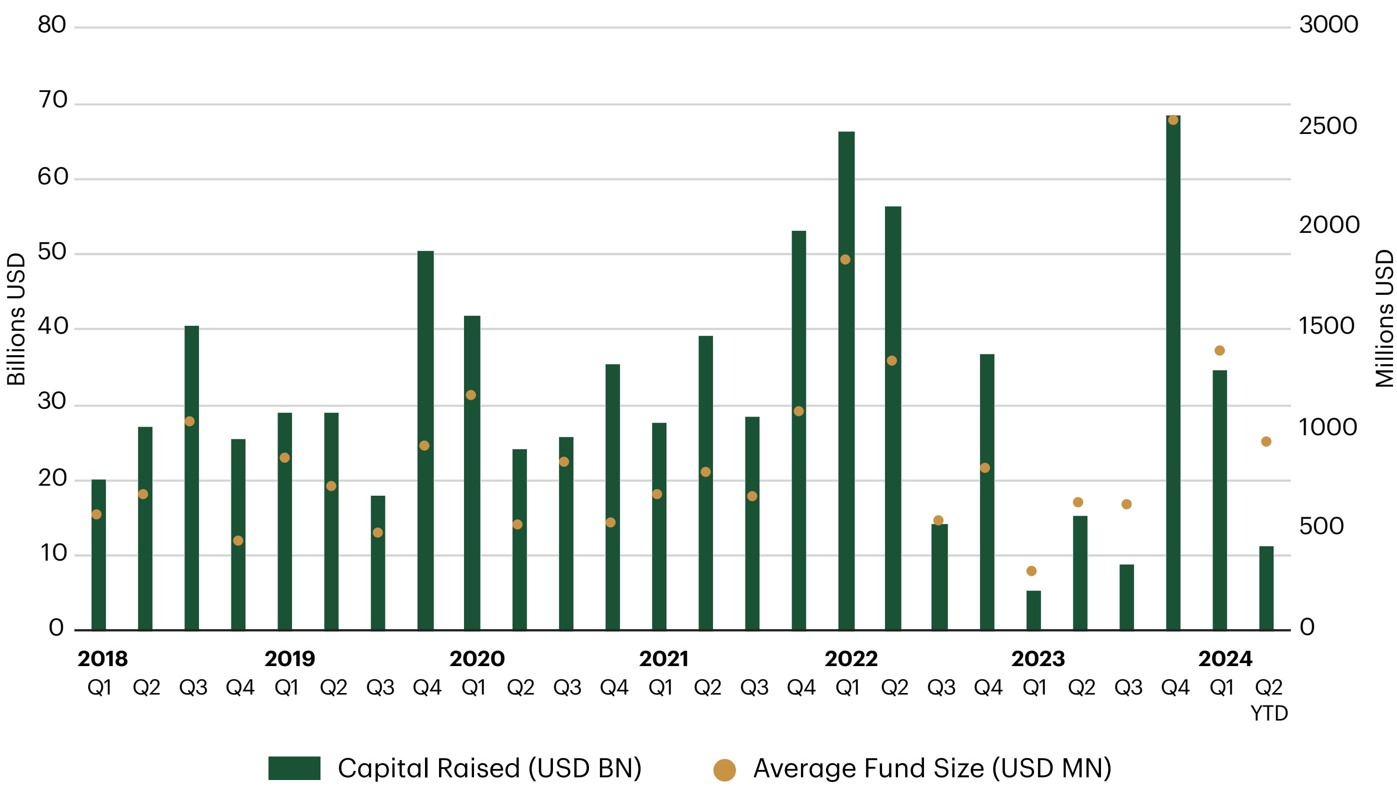
Multi-unit Residential

Global Infrastructure

The global infrastructure market has begun to stabilize as shown in the resurgence in fundraising and transaction activity. Infrastructure returns have also demonstrated resiliency, promoting investors to adjust allocations and explore major themes like transportation and telecommunications.

Figure 17: Capital Raised and Average Fund Size

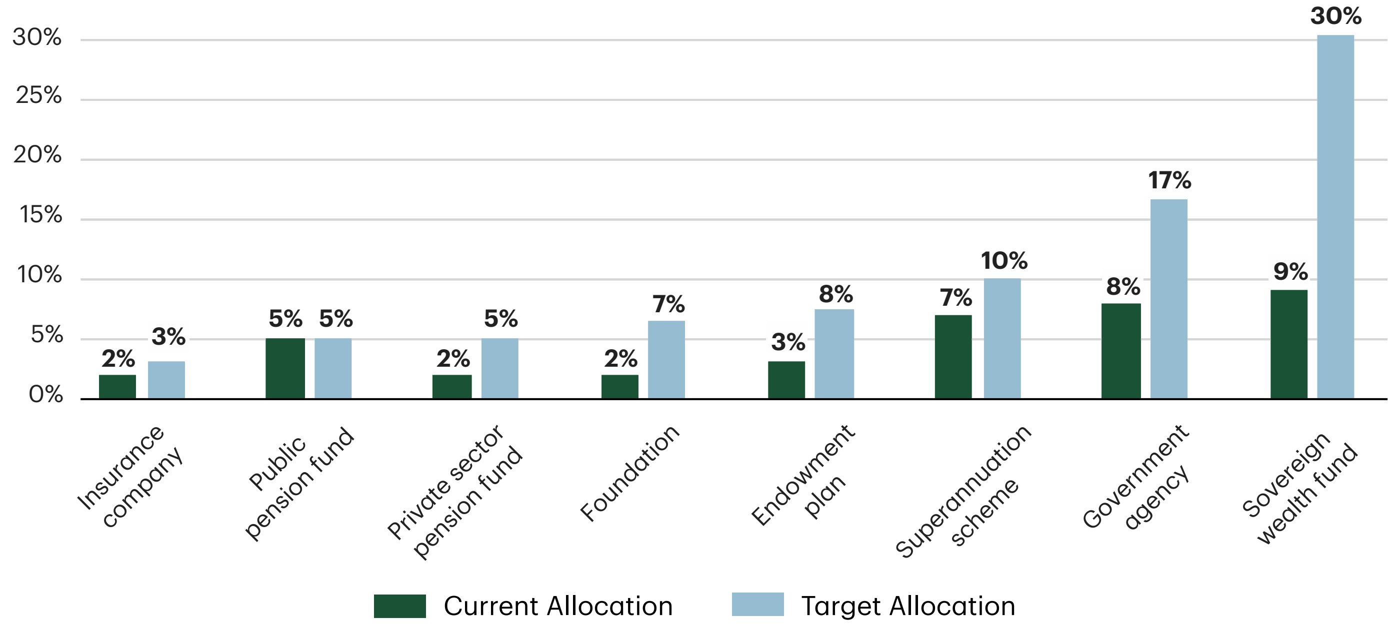
Source: Preqin, May 2024.



In 2023, only US$97.9 billion was raised, marking the lowest fund-raising year in a decade. However, the fourth quarter saw a dramatic increase, with US$68.52 billion raised (Figure 17), which is more than in the previous three preceding quarters combined.[32] As such, capital allocators (i.e., investors) have shown willingness to enter the market and avoid first-close risk however, target allocation for investors still remain below target, as illustrated in Figure 18.

Figure 18: Infrastructure Allocations by Type of Investor

Source: Preqin, May 2024.



The macroeconomic environment has increased business costs and led investors to concentrate on core plus and value-add strategies. Typically, there is an inflation-linkage of infrastructure assets where costs usually trickle down to the end users. However, with high risk-free rates, investment management firms have tilted towards higher return strategies to provide their clients with suitable returns.

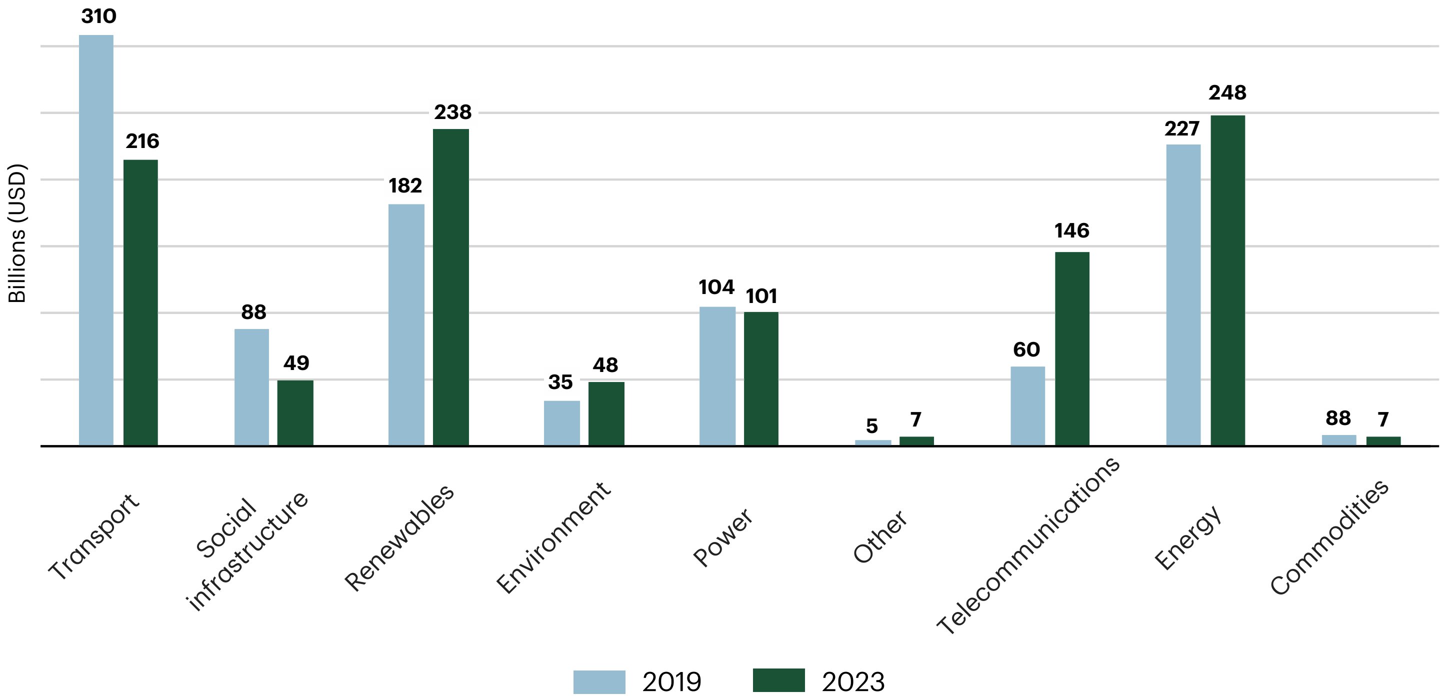
The COVID-19 pandemic affected transport infrastructure assets to a large degree by not allowing travel to the global masses along with troubles in supply chains. This led to a decline in deal volumes within the transportation sector and risk premiums to increase over the years. Now that trade volume and passenger numbers are approaching pre-pandemic levels, transportation assets are normalizing in transaction activity but still are not at 2019 volumes, shown in Figure 19. In addition, tailwinds such as onshoring industrial capacity will create demand for transport assets going forward.

Returns

[32] Preqin. May 2024.

Figure 19: Infrastructure Deal Total by Category

Source: Infralogic, May 2024.



The telecommunications sector within infrastructure has been experiencing increased investment volume over the past three years. Year-to-date 2024, we have already seen a third of last year's deal total.[33] Data centers were the proponent of this growth due to generative artificial intelligence becoming a tailwind, boosting information technology spending. AI is becoming a crucial business component for large hyperscale companies and big tech. These are the largest customers for data storage and lead total demand for the AI industry. Over the next 10 years the AI industry is anticipated to grow 42% annually, providing an enormous opportunity for investors.[34] These artificial intelligence compatible data centers require immense power compared to their traditional counterparts, providing another funding opportunity for private infrastructure funds through battery storage and renewable energy sources.

[33]Inframation. As of May 31, 2024.
[34]Bloomberg. June 2023.
https://www.bloomberg.com/company/press/generative-ai-to-become-a-1-3-trillion-market-by-2032-research-finds/ >

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