

The Canadian Industrial Market:

Why It Will Continue To Defy Gravity

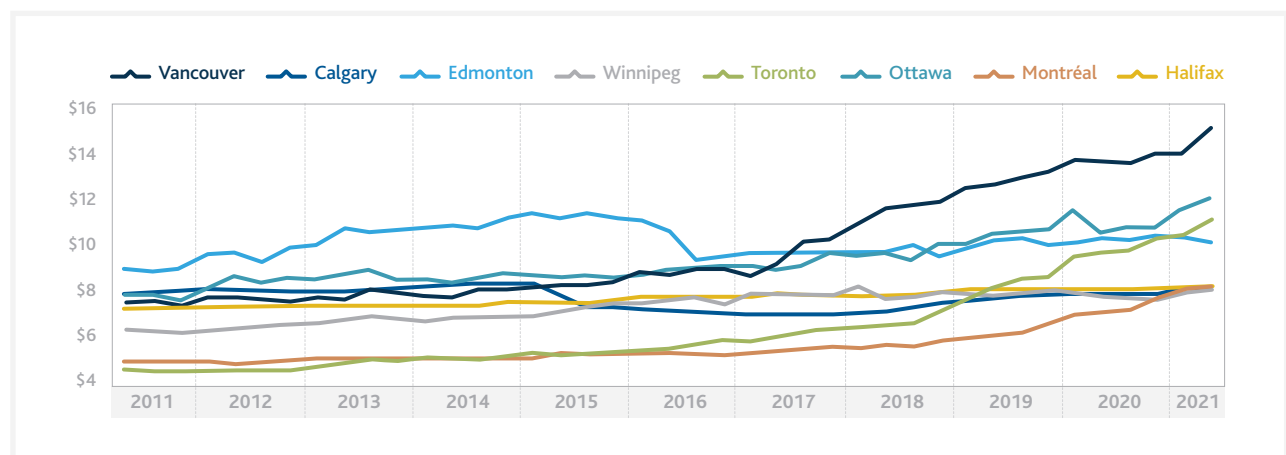


The Canadian Industrial Market Growth Story

The Canadian industrial real estate market has experienced tremendous growth over the last ten years, accelerating its pace in the last few years especially. The fundamentals have been and will continue to be exceptionally strong. Below are summary graphs of key industrial metrics on a market-by-market basis over the last 10 years (Q2 2011 - Q2 2021). All industrial markets have seen growth in net rents over

the 10-year period with some clear outperformers in the nation's major markets of Toronto, Vancouver, and Montreal, experiencing 9.0%, 7.1%, and 5.1% annualized, respectively. Looking at these same cities over the last five years' timeframe (Q2 2016 - Q2 2021), there is a marked acceleration in growth rates of 14.9%, 11.4%, and 8.8% annualized.³

Canadian Industrial Market Net Rents Per Square Foot



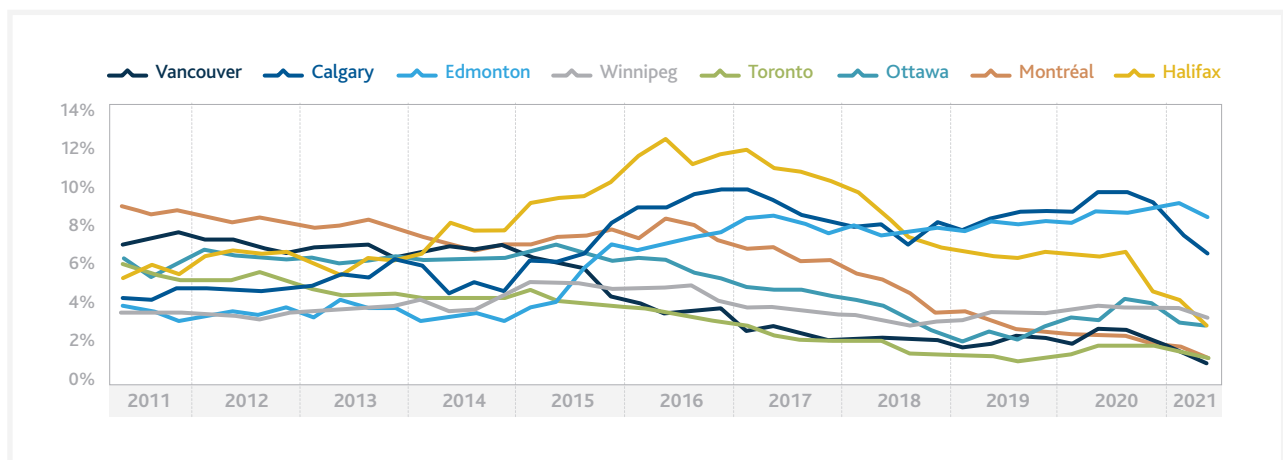
Source: CBRE

Continued strength is being confirmed recently as every single Canadian market saw availability rate contractions in Q2 2021. All markets outside of the Prairies now have availability rates of 3.0% or less, including the three largest markets: Toronto (1.2%), Vancouver (1.1%), and Montreal (1.4%). With national availability rates at 2.3%, and assuming a run-rate of 10 million square feet quarterly absorption with no new supply added, in

just over a year, there will be a 0% national availability rate. The market will simply have no space available for tenants desperately seeking space to operate.

It is no surprise that rents and values are defying gravity as they continue to levitate higher given e-commerce tailwinds driving record high absorption and levels of investor appetite contributing to capitalization rate compression.

Canadian Industrial Market Availability Rates



Source: CBRE

The Impact of the COVID-19 Pandemic

The COVID-19 pandemic (the “Pandemic”) created the ultimate litmus test of all real estate sectors’ fundamentals. The industrial sector clearly outshone all others, re-defining the word resiliency.

In fact, the Pandemic, in many ways, served as an accelerant to fuel future growth. According to eMarketer,¹ e-commerce grew an astounding 75.0% in Canada last year – the second highest growth rate in the world. The Pandemic has also forced suppliers of goods to pivot dramatically by storing more goods in inventory domestically to avoid supply chain disruptions and, as a result, warehouse space in Canada is effectively running out. The manufacturing sector will also need to adapt as the developed world was surprisingly alarmed at how reliant it is on China and other countries to manufacture vital inputs. Key manufacturing processes will have to be “on-shored” to avoid future supply chain crises. To show early proof of this thesis, if 10.4 million square feet of national net absorption was a head turner for Q1 2021, according to CBRE,² Q2 2021 experienced even higher net absorption of 16.0 million square feet (+54% Q/Q). High demand levels, contracting availability rates and, resultingly, rising rents are now a long-term reality in random capitalization of industrial market.



Key Drivers of Future Growth

Why Industrial Will Continue to Perform

The E-Commerce Effect

The table below shows the full year 2018 to YTD Q2 2021 percentage of industrial space leased by tenant industry. The figures are derived from the top 100 largest lease transactions. E-commerce's share has captured the largest incremental market share (an 8.7% increase from 2018 to Q2 2021), currently

residing in second only to Transportation/Distribution, which, arguably, is another industry also being driven by e-commerce.

This is a secular trend that does not appear to be slowing and suggests that the e-commerce industry is the key incremental driver of industrial absorption across the country.

Top 100 Largest Lease Transactions, Tenant Profile

Tenant Industry	2018	2019	2020	YTD Q2 2021
Transportation/Distribution	34.6%	30.2%	14.9%	32.6%
E-Commerce	11.8%	10.6%	25.0%	20.5%
Retail/Wholesale	17.0%	20.4%	25.3%	11.7%
Goods Manufacturing	6.9%	7.0%	5.1%	6.8%
Motor Vehicles & Parts Manufacturing	7.5%	2.2%	5.1%	4.2%
All Other Industries	22.2%	29.6%	24.6%	24.2%

YTD 2021 is inclusive of Q1-Q2 transactions. Source: CBRE Research, Q2 2021.

The Math

E-Commerce Growth and Demand for Related Transportation, Distribution & Warehouse Space

According to a report by CBRE titled *How has E-Commerce Shaped Industrial Real Estate Demand?*,⁶ looking at past relationships of e-commerce sales and related net absorption, for each incremental \$1 billion growth in e-commerce sales, an additional 1.25 million square feet of distribution space is needed to support that growth.

Looking at the eMarketer forecast below for Canadian retail e-commerce sales indicates that \$50.9 billion is the expected incremental gain in sales from 2020 to 2025.

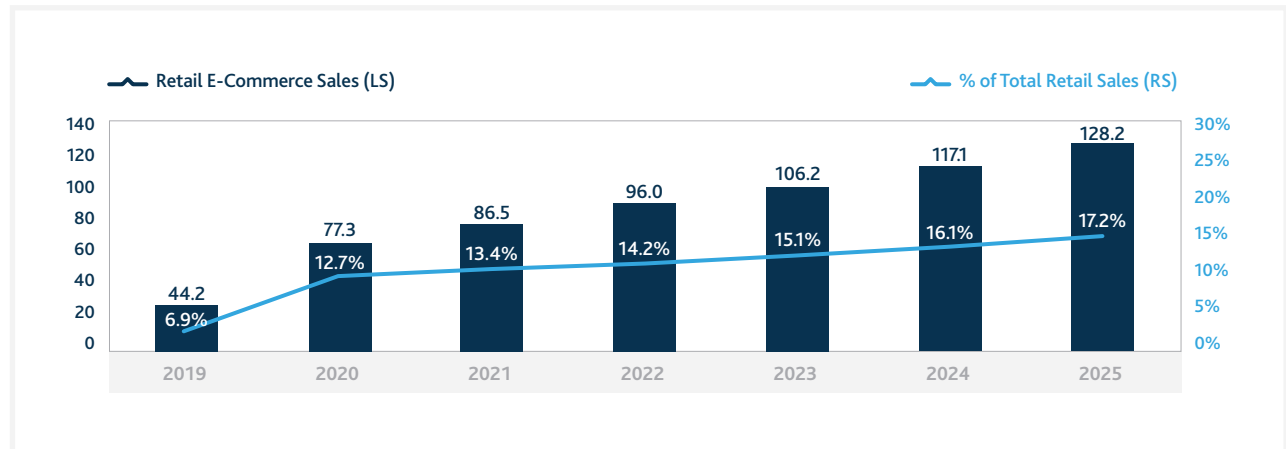
Applying the 1.25 million square feet per \$1 billion ratio would

translate to an additional 63.6 million square feet of required absorption (e-commerce uses only). With a current national industrial inventory of 1.9 billion square feet and an availability rate of only 2.3%, the anticipated e-commerce related absorption to 2025, in and of itself, is 3.3% of the country's entire inventory and greater than currently available stock.

Assuming that e-commerce leasing space remains at the current 20.5% of market share over the next five years (as per the CBRE table above), the 63.6 million square feet converts to over 310 million square feet for total industrial demand! The development pipeline, now at approximately 27.2 million square feet (representing only 1.4% of inventory), simply will not be enough to meet future demand.

Retail E-Commerce Sales in Canada, 2019-2025

Billions of C\$ and % of Total Retail Sales



Note: includes products or services ordered using the internet, 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 goods sales

Source: eMarketer, May 2021

“The math is simple;
a significant supply and demand
imbalance is certain to persist.”



E-Commerce Demand Will Continue From Amazon and Others

Amazon, the world's largest e-commerce company, has continued its dominance over the Canadian market. Much of the headline discussion around the industrial sector dynamics conveniently centres around this “Amazon effect”, but ignores more fundamental demand pressures from other more traditional industrial users such as third-party logistics (“3PLs”) companies, food service distribution centres, transportation-focused businesses, and other smaller private users, where demand for space continues to grow. The growth in industrial usage is broad-based, not solely dependent upon the success of Amazon.

Why Tenants Can and Will Pay Higher Rents

According to Cushman & Wakefield's GTA Industrial team, industrial rents typically only represent 5-10% of third-party logistics company cost structures, seeming to soften the recent arguments that tenants will not be able to afford the current industrial rents, essentially placing a cap on further rental growth. Labour, raw materials, and transportation of goods are far more significant costs for these tenants to manage. Furthermore, the profitability of e-commerce and logistics companies in Canada has never been stronger and their facilities are critical to their ongoing success. The higher rental rates can and will be absorbed by the most significant players.

While these higher rent levels are likely not a problem to bear for a company like Amazon, they may be more difficult to absorb for many traditional industrial users such as smaller 3PLs and other logistics companies as well as with smaller private businesses that tend to have relatively thinner operating margins.⁴ Resultingly, cost-sensitive users may need to step

back and analyze the decisions of how much space they can realistically afford and where it will be. For those involved in the distribution of goods, the trade-off between location or, as the case may be, delivery time relative to the cost of leasing has become an increasingly critical decision. According to Colliers' June 2021 Industrial Tenant Survey Report,⁵ if rental rates continue to rise, 62% of tenants would consider a move and, of those tenants, the vast majority (85%) would move to a more affordable suburb. There is no desire to relocate to a new province. This could ignite a rise in "secondary suburbs" that extend further beyond the city centres. Fiera Real Estate believes that these effects will lead to robust rents in these areas around primary markets. Amazon and other established 3PLs and food service providers are likely to infill more primary market spaces and further contribute to rental growth in the more prime industrial markets.

The Industry and Tenants are Reacting Quickly

Landlords and tenants alike have recognized the existing supply shortage and are reacting creatively. Some anecdotal evidence:

- ▶ Amazon is looking to secure smaller "closer-in" space to satisfy its last mile objectives. As a result, Amazon's name has also been associated with smaller warehouse deals near major population centres, across the country. For example, a site plan application in the town of Oakville on the western fringes of the GTA is nearing approval to re-develop a recently vacated industrial building just adjacent to a suburban residential neighbourhood. These closer-in warehouses are needed for Amazon to ultimately meet its promise of "one hour" delivery, just as it has done across several centres in the US.
- ▶ Also, Amazon spent \$40 million in March 2021 to buy 40 acres in the Toronto suburb of Pickering that had been home to a local flea market, according to records from data provider Altus Group⁷.
- ▶ With availability rates so tight across the country, developers are breaking ground on new product to supply options for tenants, although, as noted above, not at a sufficient pace to keep up with demand. An exceptional highlight is Panattoni building, a 2.9 million square feet robotic fulfillment centre in Parkland County just outside of Edmonton. It will be one of the largest distribution facilities in Canada when it opens in 2022⁸.
- ▶ Fiera Real Estate is actively engaged in industrial rental and condo developments and has been experiencing tenant demand even before putting a shovel in the ground – the demand is real.

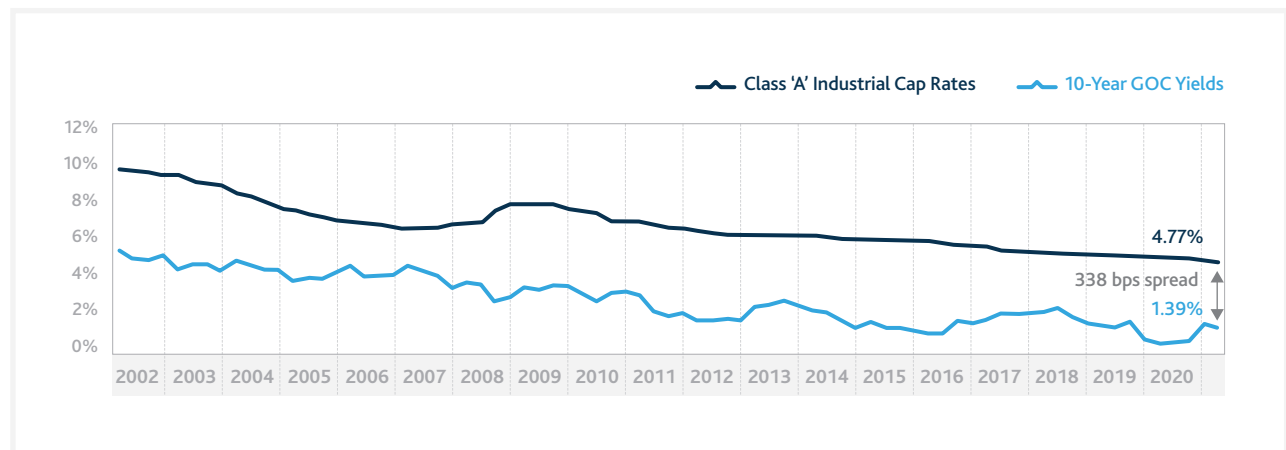
Conclusion

There are risks to being too bullish on the sector, including the possibility of a massive increase in supply of industrial product to the market through development. This risk, however, is mitigated by a lack of industrial serviced land in major markets and rising development charges along with Pandemic-related labour and supply shortages. Resultingly, warehouse space in Canada will likely not be built fast enough.⁹ The second risk is a dramatic decrease in demand. With the secular growth in e-commerce trends, continued population growth, and shifts to more domestic manufacturing, the risk of lower demand is minimal. Therefore, with a likely sustained shortage of supply and record demand, Fiera Real Estate believes the release valve will have to be Canada's industrial market net rents. That is,

net rents will need to resolve this situation by continuing to accelerate higher, especially in tight primary markets such as Toronto, Montreal, and Vancouver.

On the value side, as stated in Fiera Real Estate's last whitepaper titled *Real Estate Emerging from the COVID-19 Pandemic*¹⁰, low interest rates are likely to persist to combat aging demographics, elevated global debt levels, and deflationary forces from technological innovation. With Government of Canada ("GOC") bond yields hovering near zero offering no income growth, the industrial property type valuation looks compelling with a current capitalization spread of 338 basis points ("bps") (detailed below) over the 10-Year GOC bond yield *and* the ability to robustly grow that yield.

National Class 'A' Industrial Cap Rates vs. 10-Year GOC Yields



Source: CBRE

The Canadian industrial market will continue to defy gravity for some time to come. The mathematics supporting the supply and demand imbalance are simply too compelling and real. Rental rate growth has been at exceptional levels during this meteoric rise and will clearly continue. Those portfolios that have anticipated these trends and held overweight positions to

industrial product and land will be certain to outperform. For a property type that traditionally yielded high income returns with little capital appreciation, and, therefore, played "second fiddle" to the shiny office towers and popular enclosed malls as an investment choice, industrial is now in the spotlight as new precedents for value and appreciation are being set daily.

“Make no mistake, the Canadian industrial market will continue to defy gravity.”

Sources:

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- 2 CBRE – Canada Q2 2021 Quarterly Statistics Report
- 3 CBRE – Canada Q2 2021 Quarterly Statistics Report
- 4 CoStar – Canada Industrial National Report – Q2 2021
- 5 Colliers - June 2021 Industrial Tenant Survey Report
- 6 CBRE - Canada Market Outlook 2021 Report
- 7 <https://www.digitalcommerce360.com/2021/04/08/warehouse-space-could-run-out-in-canada-by-the-end-of-2021/>
- 8 <https://renx.ca/panattoni-build-2-9m-sq-ft-amazon-edmonton-facility/>
- 9 <https://www.evolutionfulfillment.com/ecommerce-less-warehouse-space-in-canada-2021/>
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