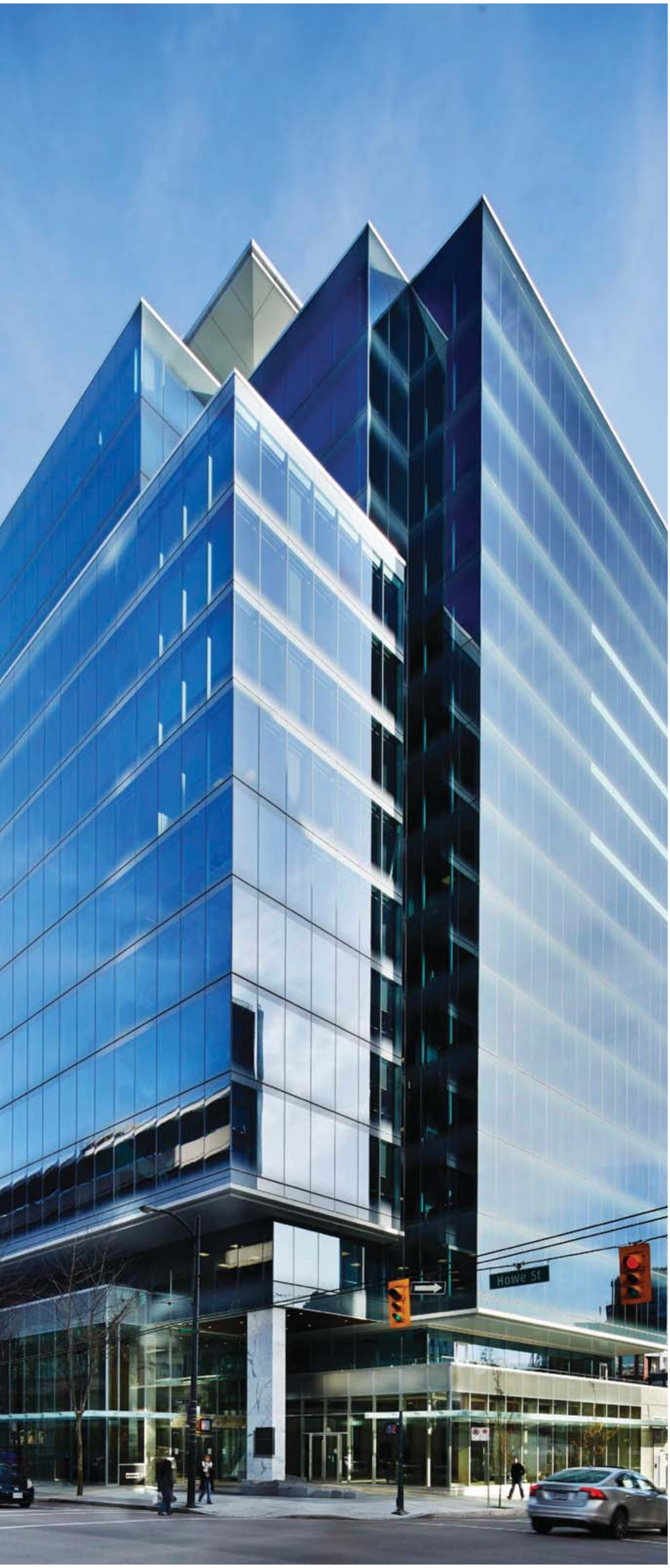


Manulife Investment Management

Canadian commercial real estate outlook

Record job gains a plus for growth, but weak business investment remains a drag

Real Estate Team
Manulife Investment Management
Q2 2019

Record job gains a plus for growth, but weak business investment remains a drag

In the first half of the year, the Canadian economy delivered to the upside with record job growth and a solid contribution from trade. A tightening labor market is sustaining wage growth, which means there's less impediment to continued consumer spending. However, weak business investment in the manufacturing and oil and gas sectors remains a drag on growth. The economy is forecast to grow modestly at 1.4% this year, but 2020 may show greater improvement, with real GDP growth expected to rebound to 1.8%.[1]

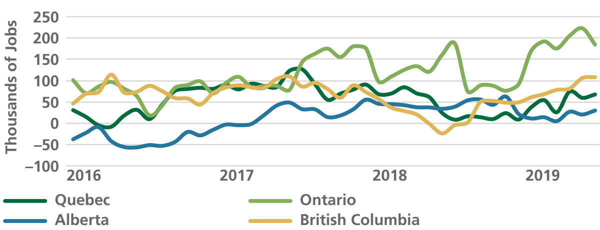
Strong job gains and low unemployment driving wage growth: In the first half of 2019, the Canadian economy generated 247,000 jobs—the highest six-month gain since 2002—pushing down unemployment to a near-historic low of 5.5%.[2] With the labor market this tight, wage growth is gathering momentum with average hourly wages increasing by 3.8% year over year as of June.[1] The synergy of job gains combined with wage growth could ease the financial pressure caused by elevated household debt and keep household spending going strong, which is forecast to grow by 2.0% this year.[1]

Ontario and British Columbia lead in job creation: Although the job market has been positive in most regions, two provinces, Ontario and British Columbia, are the primary drivers of overall job growth. Combined, these two regions accounted for 69% of all jobs created in the trailing twelve-month period ended June 2019.[2] With Toronto and Vancouver being very attractive places to live, especially for new immigrants, labor force expansion and employment growth in these regions is on track to outpace the rest of the country in the medium term.

Business investment in the goods-producing sector is still weak, but investment in the service-industry sector continues to grow: Global trade uncertainties are taking a toll on business confidence, as evident from the manufacturing sentiment index falling to its lowest level in the past three years.[3] Oil price volatility and transportation bottlenecks only add to issues for oil and gas investment, which is forecast to continue downward this year.[1] While business investment in the goods-producing sector continues to weaken, investment in service industries—retail, logistics, and professional services—is expanding. Healthy levels of consumer spending and government stimulus measures, allowing businesses to write off capital expenditures right away, for example, are driving business investment in those sectors.

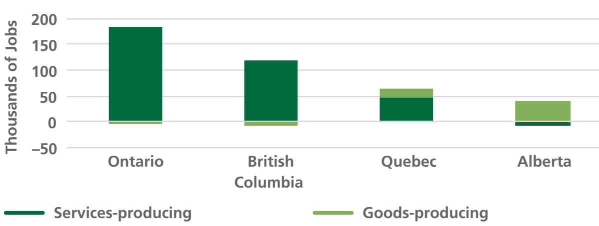
The Bank of Canada is likely to stay on the sidelines this year: While most global central banks are maintaining a dovish outlook, the Bank of Canada finds itself in a unique position: The economy has performed well to the upside, inflation is on track near its 2% target, and trade activity is strong. With these conditions holding, the Bank of Canada has signaled it's comfortable with the current benchmark rate and will likely remain on the sidelines for the rest of the year. But if the global economic outlook deteriorates further and a looser monetary policy is undertaken by the U.S. Federal Reserve, the Bank of Canada may be forced to respond with rate cuts possibly next year.

Employment growth, annual



Source: Statistics Canada, as of June 2019.

Employment growth by province, annual



Source: Statistics Canada, as of June 2019.

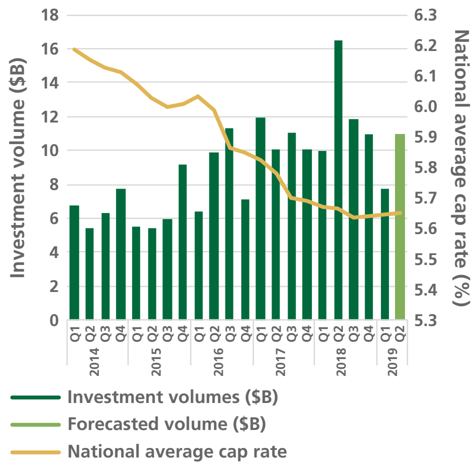
1 Conference Board of Canada, as of June 2019. **2** Statistics Canada, as of June 2019. **3** RBC Economic Research, as of June 2019.

Real estate market Q2 review and outlook[4]

Investment market

Investment activity rebounded in Q2 2019 after a tumultuous end to 2018 gave way to a subdued start to the new year in the commercial real estate sector. Investment volumes are forecast to be close to the very strong $11 billion mark in Q2 2019, with transaction velocity accelerating and several blockbuster transactions closed. Among the notable assets to trade were Bentall Centre in Vancouver, Atrium in Toronto, and 1250 boul. René-Lévesque in Montreal. Based on forecast and known activity for the second quarter, total real estate volumes for the second half of 2019 should finish somewhere between $18 billion and $20 billion. While this can leave 2019 setting a slower pace than in each of the last two years, volumes from the first half should finish well above those from the same period in any pre-2017 year on record. Encouragingly, pricing remained resilient in the second quarter despite the slowdown in transaction activity. The national average cap rate remained almost unchanged in Q2 2019, ending the period at 5.65%. Any retrenchment in yield was restricted to lower-quality assets within a narrow subset of struggling property types. The Bank of Canada's recent return to a more dovish stance on interest rates also helped ensure that spreads between real estate and benchmark bond yields have grown steadily so far this year. Investor sentiment is back on track, pricing is showing no signs of weakness, and interest rates are trending lower—all indicators that the investment landscape should stay healthy for the foreseeable future.

Canadian investment volume vs. cap rates

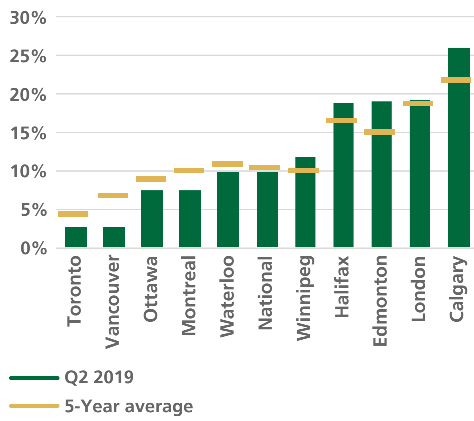


Source: CBRE Research, Realnet Canada, RealTrack Limited, Collette Plante, JLR Land Title Solutions, Real Capital Analytics, Q2 2019.

Office market

Strong demand/limited supply continues to define the office sector in Canada's gateway markets, compressing the national office vacancy rate by 20 basis points (bps) quarter over quarter to 11.3% in Q2 2019. Leasing activity was mainly concentrated in downtown markets where this quarter over 1.1 million square feet (SF) of positive net absorption was recorded, predominantly in Montreal and Toronto. Half of the 10 tracked markets in Canada currently boast downtown vacancy rates below their respective five-year averages. Technology firms continue to be a major driver of net new occupier demand across Canada, comprising the largest single industry group looking for space and 19.4% of all tenants in the market. Record market fundamentals prevail in Canada's two largest tech hubs of Vancouver and Toronto. Both are able to boast the lowest downtown office vacancy rates in North America at 2.6% in Q2 2019. The suburban

Downtown vacancy rate vs. 5-year average



Source: CBRE Research, as of Q2 2019.

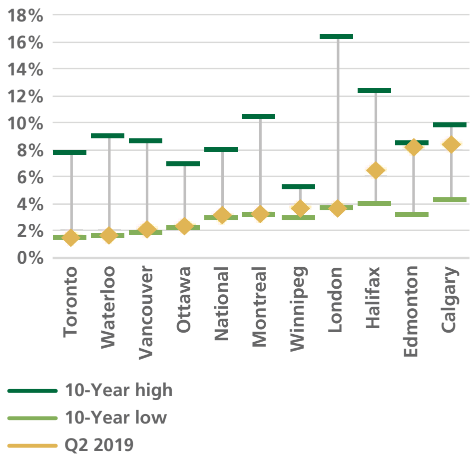
4 CBRE Research, Q2 2019.

office market in Canada has also improved, with the national overall vacancy rate contracting for the fourth consecutive quarter to 13.1% in Q2 2019, down 200bps from a year ago. Given the tight market conditions, the national office construction pipeline expanded to 17.2 million SF in the quarter, the highest level since Q3 2015.

Industrial market

In Q2 2019, for the first time in three years, the Canadian industrial sector recorded 5.2 million SF of new supply, which outpaced positive net absorption of 4.6 million SF. As a result, the national industrial availability rate increased 10bps in the quarter to 3.1%. The expanding supply is the consequence of a dwindling pool of high-quality availabilities. Strong competition for prime warehouse space in gateway markets has increased the national average asking rental rate by 15.7% year over year in Q2 2019 to $8.34 per SF. Businesses unable to meet their real estate needs with existing availabilities have begun to secure space in build-to-suit warehouse facilities rather than wait for speculative projects to begin construction; 58.2% of the 23.3 million SF under development in Canada's industrial pipeline involves design-build projects. Industrial business parks that were originally planned to be developed with multiple buildings/configurations are turning into single-tenant warehouses, which has led to fewer options for small to medium-sized tenants in the market for prime space.

Availability rate by market



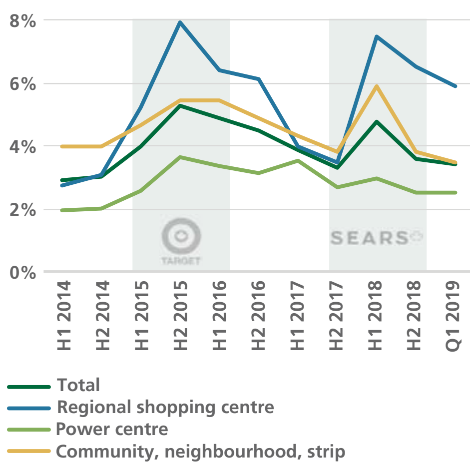
Source: CBRE Research, as of Q2 2019.

Retail market

Retail vacancy rates largely held steady in Q1 2019, though the regional shopping center segment vacancy rate saw a marked improvement with a drop of 50bps from year-end 2018 to 5.9%. Landlords continue to work through the remaining vacant Target and Sears space across the country of 17.5% and 71.4%, respectively, as of July. As an increasing number of landlords opt to subdivide and renovate the remaining Sears locations in an effort to reposition their assets, the priority for anchor space to be occupied by a single department store has diminished, ushering in a new phase of tenant mix dynamics in shopping centers.

Recent media reports have suggested that Hudson's Bay may be next to downsize. With a portfolio of 14.2 million SF for the namesake department store (excluding its outlet and home stores), even a few closures could have an adverse impact on the market. Regional malls have struggled in recent years—last year, mall productivity growth of 1.3% fell short of overall core retail sales of 2.8%.

Canadian retail vacancy rate

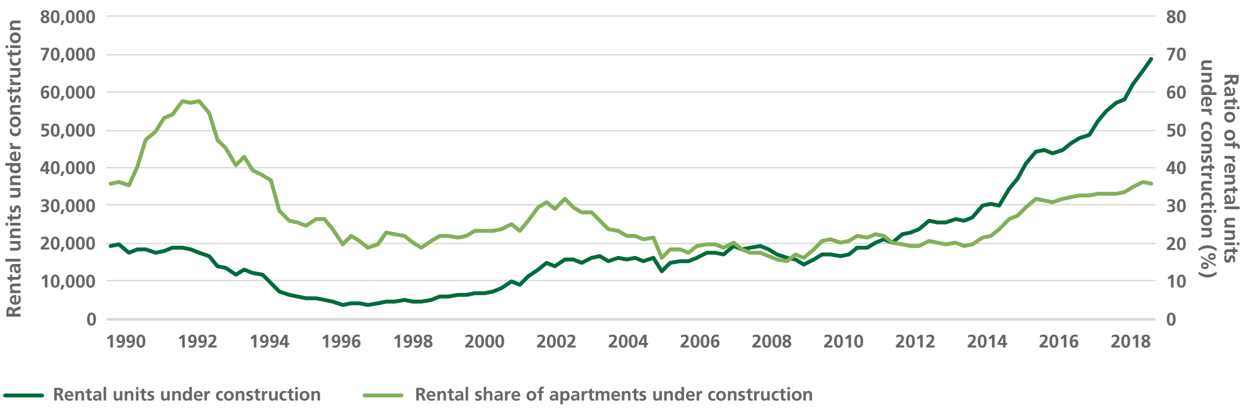


Source: Select retail REIT/REOC portfolios, CBRE Research, July 2019.

Multifamily market

Canadian multifamily fundamentals continued to tighten in 2019. Population growth, economic expansion, and shifting demographics have all increased the demand for multifamily housing in major urban centers. Along with a shift to more stringent mortgage requirements and rising home prices, these factors have significantly increased the pool of prospective renters for relatively inexpensive multifamily units. The supply of quality multifamily units in major markets has remained limited, one reason being that apartment construction in Canada had been heavily weighted toward condominium projects. In 2008, only 16% of all apartments under construction were designated as rental units. Since then, however, the allocation to purpose-built rental has slowly been shifting with 68,626 units under construction as of Q2 2019—the highest level on record—representing 36% of total multifamily construction activity. With occupancy levels for existing stock at nearly 100%, rapidly rising rents and demand showing no signs of slowing any time soon, this welcome change should provide some balance to the market for renters and landlords alike.

Multifamily under construction inventories

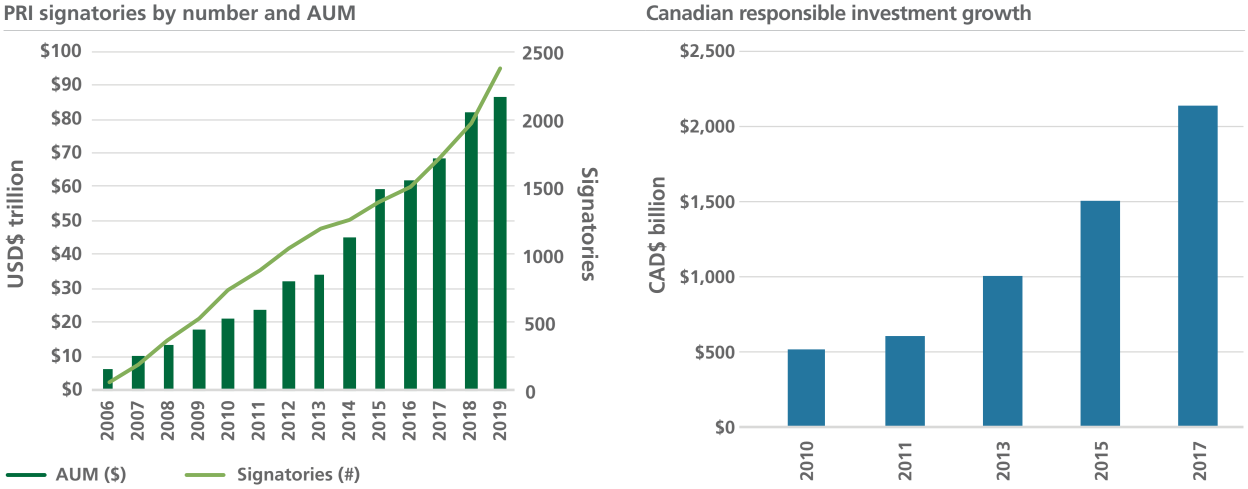


Source: CMHC, Q2 2019.

Real estate ESG integration

The rise of ESG integration

Investors are increasingly incorporating environmental, social, and governance (ESG) considerations into their investment management practices. Globally, asset owners and investment managers representing more than US$80 trillion have committed to integrate ESG into their investment process as signatories to the Principles for Responsible Investment (PRI).[5] In Canada, investors representing almost 50% of the investment industry report "ESG integration" as a component of their investment approach.[6]



Source: Principles for Responsible Investment as at June 1, 2019;[7] Responsible Investment Association, 2018.[8]

The business case—protect and enhance long-term value

ESG integration helps investors identify investment opportunities and manage risks, which in turn helps protect and enhance long-term value. In real estate investment, ESG business opportunities include reducing operating costs through resource efficiency, meeting customer demand for green and healthy workspaces, and creating stronger tenant relations by engaging tenants and understanding their needs. Managing risk includes staying ahead of regulations such as mandatory building energy benchmarking or carbon pricing, avoiding health and safety and environmental incidents, and addressing the physical risks associated with a changing climate.

ESG integration isn't new. For quite a while now, investors have taken ESG factors into consideration, particularly governance aspects such as management oversight and the presence of compliance mechanisms. Many ESG issues, however, are becoming ever more material, driven in part by global megatrends like climate change, shifting demographics and the rise of millennials, technology, and global connectedness. In addition, ESG data and best practices have expanded over the past ten years and are much more prevalent.

5 Source: Principles for Responsible Investment, 2019. 6 Source: Responsible Investment Association, 2018. 7 Source: Principles for Responsible Investment, 2019. 8 Source: Responsible Investment Association, 2018.

Real estate ESG standards—codifying best practices

Material ESG factors for any investment depend on the industry and market. For example, child labor may be material to a clothing manufacturer with supply chains in developing countries, but not material to domestic Canadian real estate. Commonly accepted ESG or "sustainability" aspects in real estate include:

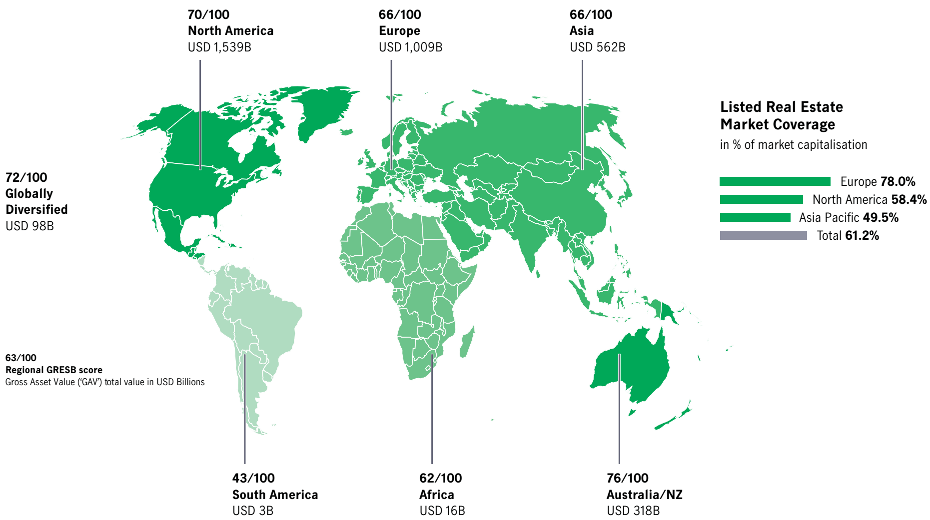
- **Environment:** energy and water consumption, greenhouse gas emissions, waste and recycling, environmental attributes of building materials and environmental compliance
- **Social:** engagement with tenants, community and suppliers, building safety, occupant and community health and wellbeing, diversity and inclusion
- **Governance:** compliance and oversight, policies and procedures, risk management practices, reporting and transparency

To help investors and other stakeholders understand real estate ESG performance, there are common standards that distill ESG aspects into simple comparable metrics.

At the asset level, green building certifications indicate strong environmental and social practices. Common sustainability certification schemes in Canada include LEED®, BOMA BEST®, and ENERGY STAR™. Fitwel and WELL™ are asset-level certifications that focus solely on health and wellbeing and Wired Score is a standard that validates a building's digital infrastructure.

For funds and portfolios, the Global Real Estate Sustainability Benchmark (GRESB) assessment is the international standard. GRESB was initiated by investors who wanted to be aware of the ESG performance of funds they invest in. It's supported by investors representing more than US$17 trillion in institutional capital.[9] GRESB assesses a fund manager's ESG management practices, policies, systems and engagement practices, and benchmarks the sustainability performance of a fund's underlying assets. Now in its 11th year, the assessment includes 903 companies and funds with 79,000 assets representing USD$3.7 trillion in GAV.[10]

GRESB Participants, Average Score and Market Coverarge



Source: GRESB, 2018.[11]

9 Source: GRESB, 2019. **10** Source: GRESB, 2018. **11** Source: GRESB, 2018.

The business case—empirical evidence

The increased focus on ESG is, in part, driven by empirical evidence that supports the business case. At the asset level, studies link building certifications to increased financial returns. One study of over 300 North American office buildings found that over a ten-year period, ESG certifications were linked to higher net effective rents, lower rent concessions, higher occupancy rates, higher tenant satisfaction, higher tenant renewals and lower energy consumption.[12] Additionally, demand for ESG certifications is increasing. Within major Canadian and U.S. markets, green certified office space has increased to over 50% and 23%, respectively, since 2006.[13]

At the fund level, studies use GRESB scores to demonstrate that stronger ESG management tend to lead financial outperformance. A 2017 study of European real estate funds found that a 10-point higher GRESB score corresponded to a 34bps increase in fund return. The study showed ESG to be a predictor of financial performance even when controlling for fund size, leverage, style, and construction.[14] Another study looking at global REITs over a three-year span found that a 1.0% increase in GRESB score corresponded to a 1.3% increase in return on assets and a 3.4% increase in return on equity.

While this empirical data is indicating benefits, the studies don't cover all geographies and asset classes. At this time, effective ESG implementation requires investment manager judgement and expertise to capture gains that exceed costs.

Emerging ESG trends

ESG isn't static. New issues become material as global, regional, and industry trends shift. In real estate, there are several emerging ESG trends.

- **Climate change**—Real estate investment managers are beginning to prepare for the transition to a low-carbon economy and assess the physical impacts a changing climate may have on their portfolios.
- **Health and wellbeing**—Studies conducted by Harvard University validated the link between green building certifications and improved health and productivity outcomes.[15] New certification schemes focusing solely on health and well-being are being adopted across North America, as real estate managers look to highlight operational practices that support health and well-being.
- **Building energy and water performance**—Many municipalities and regions in North America now mandate building energy and water reporting and some require compliance to efficiency standards. For example, in New York, buildings not meeting a minimum standard must be upgraded. Increased transparency and requirements mean that energy and water performance may eventually impact leasing and asset valuation.

ESG integration at Manulife Investment Management

Manulife has a strong track record of ESG integration in real estate management. We've participated in the GRESB Assessment since 2015, achieving year-over-year performance improvements and receiving a Green Star ranking for all our funds. We also received an A on the PRI Direct Property Investing assessment. Additionally, more than 80% of our global portfolio by square feet is certified to LEED, BOMA BEST, or ENERGY STAR. For more information on our ESG practices and performance, please see our 2019 Real Estate Sustainability Report.

12 Source: Avis Devine and Nils Kok, Journal of Portfolio Management, 2015. **13** Source: CBRE, 2018.**14** Source: Dirk Brounen and Maarten van der Speck, TIAS School for Business and Society, 2018. **15** Source: Joseph G. Allen, et. al, Environmental Health Perspectives, 2019.

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