Perspective 2017

Canada

Bentall Kennedy

One York, Toronto, ON
Owned by: Menkes, HOOPP and Sun Life Financial
Managed by: Menkes

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Executive Overview

$51.91

NOMINAL PRICE OF OIL, WEEK OF DEC. 16, 2016, UP 71% FROM THE 13-YEAR LOW SET IN FEB. 2016

SLOW GLOBAL GROWTH, HIGH UNCERTAINTY

—A wave of national populism is sweeping the globe resulting in changes in the status quo for geopolitical relations and creating social unrest in some countries.

—Global economic growth is persistent, albeit lackluster, as aggressive monetary policy has proven an insufficient catalyst for stronger economic activity.

—China's GDP growth has stabilized at just under 7.0%, the slowest pace in over 25 years.

—Weakness in Europe is weighing down the global economy.

—The steady U.S. economy and recent gains in oil prices (which should benefit struggling oil exporting nations) suggest there is potential for brighter days ahead.

U.S. ECONOMY HOLDING FIRM, DESPITE HEADWINDS

—A tight labour market is driving wages higher, fueling healthy growth in consumption. Job gains are moderating as available labour is scarce.

—U.S. firms are benefiting from expanding domestic demand. However, weak growth abroad and a rising dollar have presented headwinds that should persist in 2017.

—Uncertainty is high as the incoming Trump administration poses both upside and downside risks to growth. Tax, trade, immigration, and regulatory policy changes are all expected.

—Our outlook remains positive with expectations for improved growth in 2017 aided by stimulative fiscal policy (lower taxes and increased government spending).

CANADA STRUGGLES TO GET BACK ON TRACK

—A strengthening U.S. economy and improved competitiveness of the Canadian dollar should translate into better growth prospects for exports. However, protectionist sentiment poses a major downside risk to the Canadian trade sector.

—Stabilization in oil prices supported by a coordinated production-cut agreement by OPEC and some non-OPEC members is supportive of a modest rebound in the energy sector.

—A soft landing is anticipated in the housing market amidst a backdrop of higher mortgage rates and tighter lending rules imposed by the federal government. However, housing should continue to be a key economic driver.

—Overall fiscal and monetary policy environment remains transparent and highly stimulative, providing an environment for improved growth in 2017.

INSATIABLE APPETITE FOR HIGH QUALITY REAL ESTATE

—Fueled by an abundant availability of debt capital and record low interest rates, 2016 investment volumes are anticipated to exceed $35 billion, surpassing the peak of the prior cycle in 2007.

—Foreign investment in Canadian real estate is anticipated to persist as the gateway cities of Toronto and Vancouver are considered a safe-haven for global capital.

—Regional divergences in economic growth, property fundamentals, cap rates, and ultimately investment performance are anticipated to continue into 2017.

—Risk-adjusted real estate returns remain attractive relative to other asset classes. However, future returns are expected to become income oriented, enhanced with capital appreciation driven predominantly by modest NOI growth.

NATIONAL OFFICE VACANCY EXCEEDS LONG-TERM AVERAGE

—Most markets are entrenched in a "tenant favourable" stage as the national vacancy rate has surpassed 13% and rents softened as a result of weaker demand and a robust development pipeline.

—National figures mask vast regional differences. Strong demand from the tech sector is driving absorption in the Vancouver and Toronto markets while weakness continues in the energy-dependent markets of Calgary and Edmonton.

—As a result of an active development cycle, supply continues to outweigh demand, particularly in Calgary and Edmonton and, to a lesser extent, Montreal and Vancouver.

—Office demand should see a modest improvement in line with improving economic growth expectations in 2017. Overall, the level of new construction is anticipated to exert upward pressure on vacancy and weigh on market rents, but is unlikely to create any significant dislocation.

MAINTAINING A FOOTING ON A SHIFTING RETAIL LANDSCAPE

—Retail sales continue to grow at a moderating level; however, headwinds are emerging as leveraged consumers are likely to face increased debt servicing costs. Property fundamentals remain healthy for urban formats and super-regional malls, while continued divergence is anticipated for secondary and tertiary markets and assets.

—Changing spending patterns, including increasing growth in ecommerce, rising demand for experiential retail offerings, and a growing concentration of sales in urban retail nodes are disrupting space demand.

—New retail construction remains restrained as developers focused on new and redevelopment opportunities as part of urban mixed-use communities, while retailers allocate capital to building out their distribution networks to handle growing ecommerce volume.

$35b

FULL-YEAR 2016 TRANSACTION VOLUME FORECAST; CBRE

7.4%

TOTAL RETURN, MSCI REALPAC/IPD CANADA PROPERTY INDEX, TWELVE-MONTH PERIOD ENDING Q3 2016

—Changes in the retail market are more than cyclical as ecommerce grabs a larger and larger piece of activity with each passing year. The market will continue to reveal stark differences between winners and losers, even as retailers strive to employ omni-channel sales strategies to better compete with Amazon.

INDUSTRIAL FUNDAMENTALS CONTINUE TO TIGHTEN

—Industrial availability has been on a steady downward trend since the financial crisis, providing upward pressure on rental rates. While construction deliveries are anticipated to slow relative to the robust activity of the prior four years, absorption could surprise to the upside with mounting secular tailwinds.

—Improving industrial demand stateside and a lower exchange rate should support demand for manufacturing space. Surging e-commerce demand will continue to be a boon for the industrial market with distribution space essentially replacing brick and mortar retail in some cases.

—The need for modern, efficient distribution oriented space with high clear heights, ample trailer parking, and proximity to major population centres and key transportation networks has spurred most of the recent industrial construction activity. While construction activity has slowed this past year, it's expected to remain steady moving forward to satiate growing warehousing demand closer to the core.

—Developers remain prudent despite healthy fundamentals and robust recent demand. Expect to see restraint continue with uncertainty around the future of U.S. trade under a Trump administration and hesitation until more traditional retailers begin to unveil their logistics strategies.

MULTI-RESIDENTIAL, TOP PERFORMING SECTOR

—Although vacancy increased slightly over the past year, property fundamentals remain landlord favourable leading to rent growth in most non-energy dependent markets. Alberta continues to see elevated levels of vacancy and deteriorating market rents exacerbated by a glut of new supply.

—Robust immigration, urbanization, and deteriorating housing affordability are strong secular tailwinds for the sector.

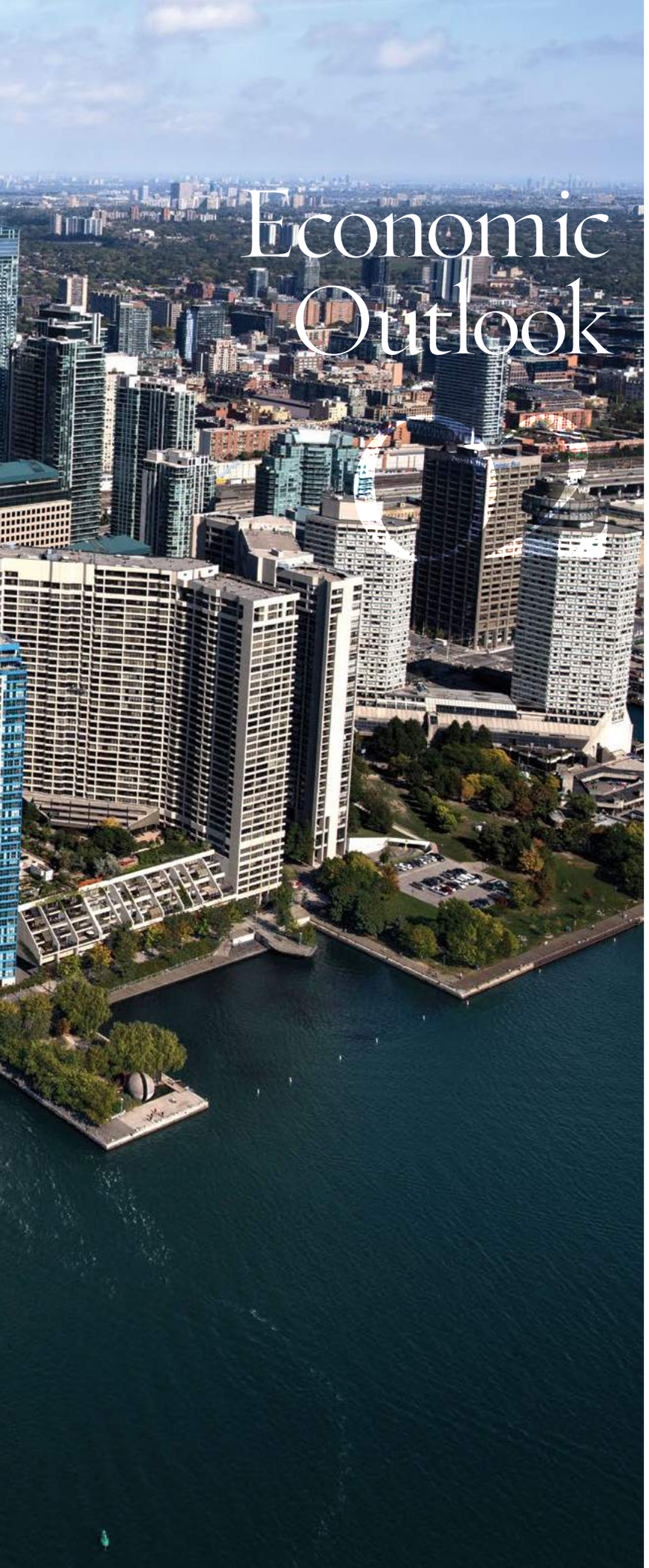
—Purpose-built rental and condo housing starts are down slightly year-over-year but remain well above the long-term average. Conservative underwriting by lenders amidst increasing concern over a housing bubble will help to keep oversupply in check.

—Strong secular demand trends should continue to fuel an increased desire for modern purpose-built rental accommodations, preserving landlord favourable conditions throughout most of the country. The ability to deliver new product above development cost and the defensive nature of the asset class will attract further capital into the sector.

Heightened political and economic uncertainty across the globe is having a significant impact on the Canadian real estate market. Global capital is increasingly finding a home in Canadian markets for capital preservation and diversification benefits. Foreign investment capital is a competitive force that domestic players have not encountered to this degree before, as they also deploy record levels of capital in search for yield. Prudent assessment of macroeconomic risks, foresight into rapidly evolving secular trends, and an exceptional understanding of local market conditions will be imperative to unlocking attractive returns at this late stage in the cycle. Deeper analysis of these trends and discussion of our outlook are available in the pages that follow. We hope you find this redesigned edition of Perspective informative and insightful.

Olympic Village
Vancouver, BC

One York
Toronto, ON



Economic Outlook

GLOBAL

—A wave of national populism is sweeping the globe resulting in changes in the status quo for geopolitical relations and creating social unrest in some countries.

—Global economic growth is persistent, albeit lackluster, as aggressive monetary policy has proven an insufficient catalyst for stronger economic activity.

—China's GDP growth has stabilized at just under 7.0%, the slowest pace in over 25 years.

—Weakness in Europe is weighing down the global economy. GDP growth is trending below 2.0% in the European Union.

UNITED STATES

—A tight labour market is driving wages higher, fueling healthy growth in consumption. Job gains are moderating as available labour is scarce.

—U.S. firms are benefiting from expanding domestic demand. However, weak growth abroad and a rising dollar have presented headwinds that should persist in 2017.

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CANADA

—A strengthening U.S. economy and improved competitiveness of the Canadian dollar should translate into better growth prospects for exports. However, protectionist sentiment poses a major downside risk to the Canadian trade sector.

—Stabilization in oil prices supported by a coordinated production-cut agreement by OPEC and some non-OPEC members is supportive of a modest rebound in the energy sector.

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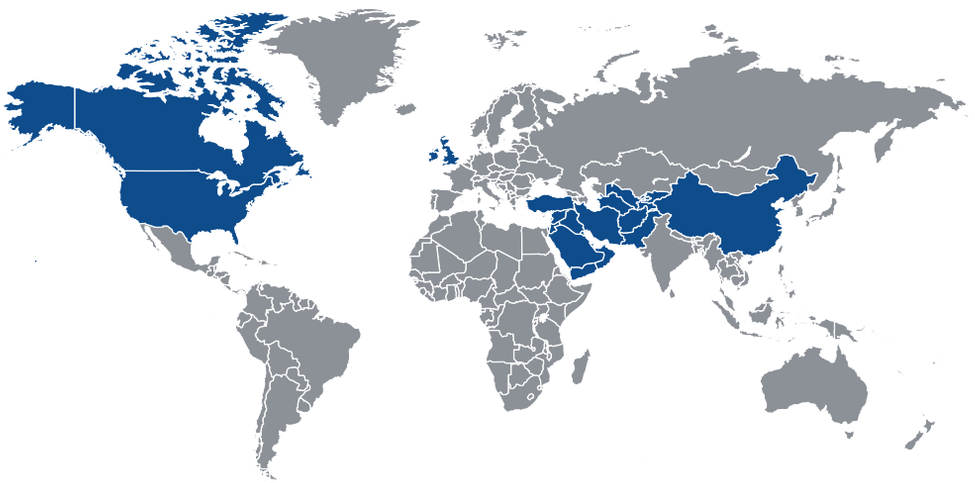
Global Economy: Slow growth, high uncertainty



No one event was more emblematic of global social, political and economic conditions over the past year than the June 2016 "Brexit" vote, in which citizens of the U.K. voted to exit the European Union. The heated debate leading up to and following the vote pitted national populism against globalism, with working-class voters essentially lashing out against the immigration and trade policies of their government—echoes of this were also evident in the election of Donald Trump as president of the U.S. Brexit elevated uncertainty across the global economy and exacerbated already volatile financial market conditions. After the vote, stock markets plunged worldwide and the British pound was heavily sold off. But reactionary market fluctuations seem to have given way to a wait-and-see approach. Markets have since rebounded, and it is even possible that Brexit may never actually happen.

In an uncertain economic environment such as this we must:

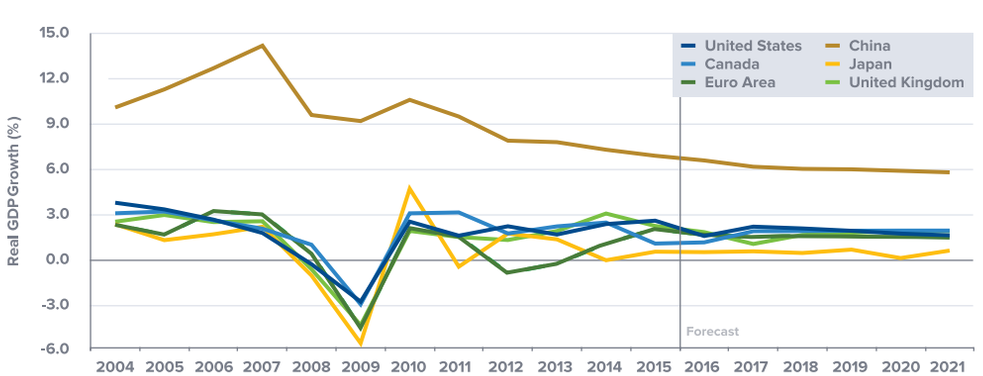
—Acknowledge known unknowns (Brexit vote, Trump election)
—Not become frozen by the prospect of unknown unknowns (black swan events: war, financial market shocks)
—Closely analyze trends in known data (slower growth in China, continued U.S. expansion)

Through this lens we see a global economy that is growing slowly, but persistently. We also see low and even negative interest rates as central banks across the globe work to stimulate their economies. The European Central Bank remains particularly active as it struggles with low growth and high unemployment. With inflation remaining low there seems to be little to deter them from keeping current policy in place.

Government bond yields in some countries are negative, even towards the longer end of the yield curve, and we are seeing negative rates on deposit accounts. In the short run these conditions deter savings and encourage borrowing, but in the long term they risk creating dislocations—such as overheated housing markets and even insufficient retirement savings for workers unwilling to risk their limited savings in volatile public markets. The U.S. is the most notable exception to this trend, with the Fed raising interest rates 25 basis points in December 2016—including its 25 basis point hike in December 2015, this is just the second increase in 10 years. With investment yields remaining low across the globe, the flow of capital to real assets will continue.

Interestingly, a corporate bond buying program instituted by the European Central Bank (ECB) has done very little to stimulate growth. A November 2016 article in the Wall Street Journal noted that, according to data from J.P. Morgan Chase, the corporate savings rate in the Eurozone hit its highest level in 22 years. Firms seem happy to issue debt at low rates, but have little interest in putting that capital to work. It looks increasingly likely that the marginal cost of monetary policy in Europe may be outpacing the marginal benefits.

2.1 PERSISTENT, BUT UNIMPRESSIVE GLOBAL GROWTH



SOURCE: IMF, OCTOBER 2016 GLOBAL ECONOMIC OUTLOOK

$51.91

NOMINAL PRICE OF OIL, WEEK OF DEC. 16, 2016, UP 71% FROM THE 13-YEAR LOW SET IN FEB. 2016

Low commodity prices are also creating issues across the globe. This is particularly true for oil-rich nations as a glut of supply and weak global demand have decimated prices. Fortunately, the price of oil seems to be stabilizing near $50/barrel, and the worst of the pain may be over as the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC countries recently reached an agreement to cut production. In Canada we had expected weakness in commodities and the resultant fall of the Loonie to precipitate a rotation to other exports, but we acknowledge this rotation has been slow to materialize. In the U.S., low oil prices have historically corresponded with faster rates of economic growth; but given the country's increased prominence as an oil producer, there have been isolated negative ramifications in the form of job losses in regions tied to oil production and related services. U.S. consumers have conserved much of their savings on fuel, diminishing the positive impact, but raising the prospect of elevated spending over the medium term.

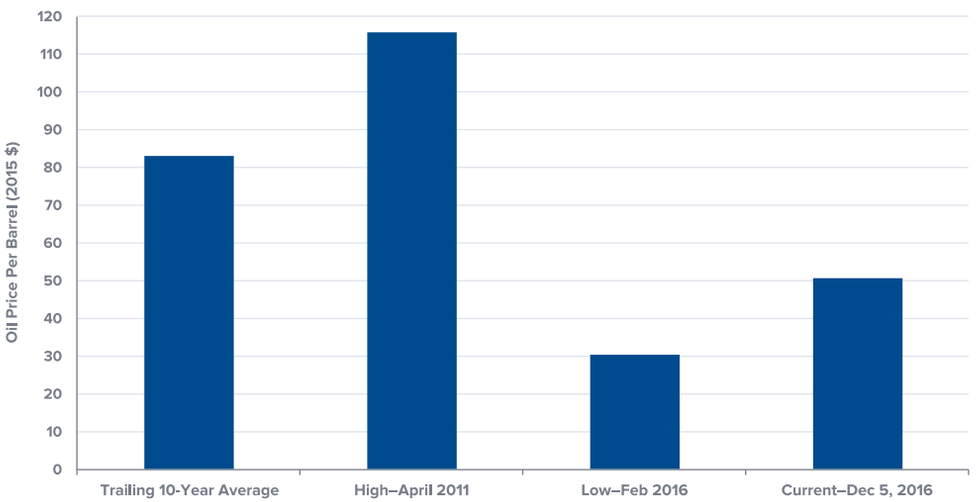
China, as the world's second-largest economy, will continue to heavily influence global growth and geopolitical relations. The country has maintained stable reported growth over the past few quarters of 6.7% annualized, in line with government targets. Stabilizing growth is a positive sign as China has run up a significant amount of debt to fund real estate and infrastructure projects in an effort to fend off a slowdown. Cheap credit has also fueled a boom in home prices. Capital outflows have been significant as investors seek stability and safety abroad, a trend that has further weakened the Yuan and is spurring the government to take action to curb outflows. Restrictive actions on Chinese investment abroad represent one of the most significant downside risks for global investment activity.

U.S. consumers have conserved much of their savings on fuel, diminishing the positive impact, but raising the prospect of elevated spending over the medium term.

Geopolitics is also likely to factor heavily into the global economic growth equation in 2017. The U.S. may potentially be a significant disruptor in this regard as President-elect Trump's policies could impact immigration patterns and trade flows. The Trans-Pacific Partnership (TPP) trade agreement seems destined for the scrap heap and the North American Free Trade Agreement (NAFTA) could also be at risk. Uncertainty around Trump's policies and his fairly bellicose language related to international trade represent significant wildcards for global growth. Escalation of conflicts within the Middle East or aggressive military actions by Russia, China, or North Korea also present downside risks.

The largest potential upside scenario would come from the U.S. if trade policy is little-changed and fiscal stimulus has the desired effect of triggering a modestly higher growth trend over the short-to-medium term. U.S. policies that stimulate growth, such as lower taxes and infrastructure investment, could have positive spillover effects for major U.S. trading partners, but also carry with them the risk of more pronounced cyclicality over the long term.

2.2 OIL PRICES HAVE REBOUNDED FROM EARLY 2016 LOWS



SOURCES: U.S. ENERGY INFORMATION ADMINISTRATION (WTI SPOT PRICE); U.S. BUREAU OF LABOUR STATISTICS

United States Economy: Holding firm, despite headwinds

The U.S. sits in familiar territory as many of the headwinds and uncertainties facing its economy a year ago remain present today. This uncertainty is amplified by the presidential election as policies under a Trump administration are difficult to predict. It is fair to say that the U.S. economic cycle is maturing. Annualized Real GDP growth averaged just 1.9% through the first three quarters of 2016—the poorest start to a year since 2012. But third quarter 2016 growth was fairly strong, at 3.5% according to the third estimate from the Bureau of Economic Analysis, and the run rate in 2016 is not off dramatically from the 2.1% pace of the prior five years.

Weak corporate profits, low unemployment, and rising wages have weighed on hiring. Employment increased by 1.6% during the year ending in November 2016—the slowest growth rate in over three years. Still, there are many reasons to be optimistic about U.S. growth, not the least of which are the 2.3 million new jobs created over the past 12 months. While the growth rate is not impressive, the volume of jobs created is significant in a historical context. Consider that job growth averaged less than 800,000 per year during 2006–15. While the employment story is a positive one, this is far from our most robust expansion cycle. The U.S. economy only employs 4.8% more workers than it did in January 2008.

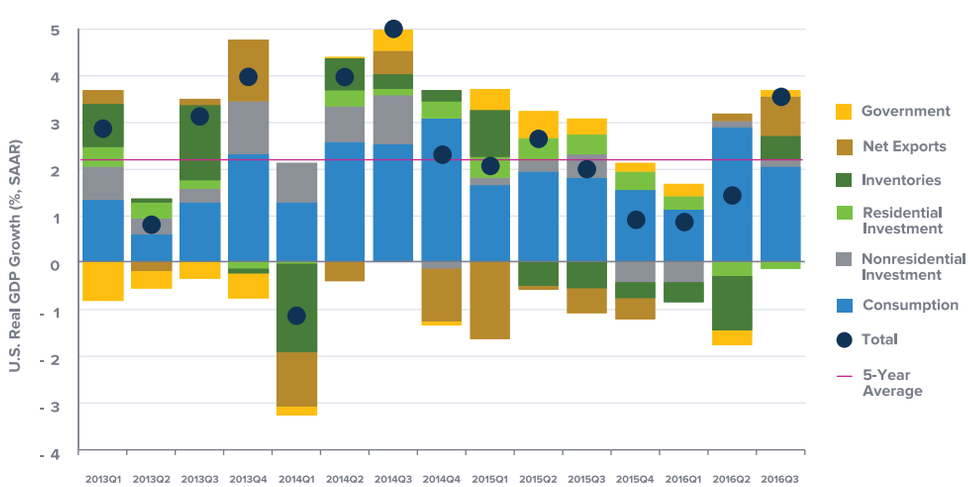
Slower job growth is broad-based, unfolding in sectors that have been key drivers of the U.S. economic recovery and, now, expansion. The professional and business services sector, which includes jobs in STEM and TAMI fields (science, technology engineering, and math; technology, advertising, media, and information) grew at a 2.9% year-over-year growth rate as of November 2016, compared to 3.3% a year earlier. This is still one of the fastest growing sectors in the economy, employing over 13.0% more workers than at its prerecession peak. Healthcare, construction, and leisure and hospitality are among the other major sectors with slowing growth.

Weak profits, low unemployment, and rising wages have weighed on hiring.

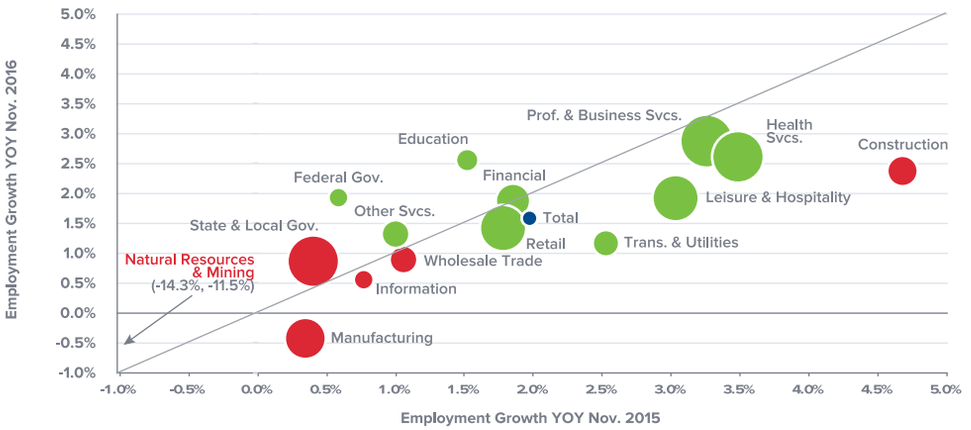
	UNEMPLOYMENT RATE	LABOUR FORCE PARTICIPATION
MAY 2007	4.4%	66.0%
NOV 2016	4.6%	62.7%

2.3 U.S. GROWTH TRENDING AROUND 2.0%

—Business investment declined in two of the last four quarters
—Residential investment (construction) has declined over the past two quarters, impacted by rising mortgage rates and scarcity of skilled labour
—Consumers continue to make a strong positive contribution to growth
—Despite strong dollar, net exports have been a tailwind



SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS



2.4 EMPLOYMENT GROWTH LED BY STEM/TAMI & HEALTHCARE

SOURCE: U.S. BUREAU OF LABOUR STATISTICS
NOTE: RED BELOW PRERECESSION PEAK; GREEN ABOVE

Conversely, government and financial activities employment are two of the major sectors that posted accelerating growth over the past year. Both sectors could continue to perform well in 2017, driven by the arrival of new government workers and the potential for some easing of the regulatory burden on financial activities firms. Financial activities employment has been a particularly soft spot throughout the recovery and expansion phases of this cycle, weighed down by regulation and also automation—with computer systems and algorithms being used increasingly to replace people. The financial activities sector now employs less than 1.0% more workers than it did in January 2008, but growth has been solid at 1.9% year-over-year as of November 2016.

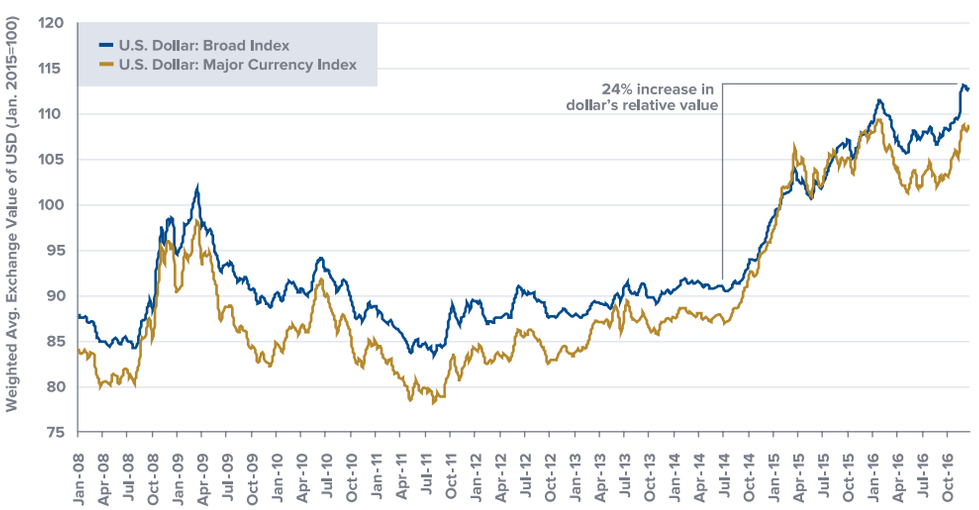
Headline unemployment is low, at 4.6%—a level that suggests the U.S. economy is near full employment. But numerous workers remain on the sidelines and the labour force participation rate is 62.7%, compared to 66.0%+ in the years leading up to the Great Recession. Initial unemployment claims are low and job openings are high, suggesting that many of the workers on the sidelines lack the skills to fill available jobs and/or live in areas where firms aren't hiring. Unemployment for professional, management, and financial occupations is less than 3.0%. Even in a tepid growth environment, the limited supply of available skilled labour will put upward pressure on wages, and may constrain growth in some heretofore fast-growing segments of the economy (e.g. technology and healthcare-related research). These labour market conditions heighten the potential risks associated with tightening immigration policies under the Trump administration.

Unemployment clearly varies by age. Population ages 20-24 and 25-34 had 8.1% and 4.8% unemployment rates, respectively, in November 2016. By comparison, less than 4.0% of workers 35 and over are unemployed. This at least partially explains the relatively slow rate of household formation among these younger workers and the diminished rate of homeownership we have seen nationwide. High levels of student loan and credit card debt are exacerbating the labour market's effect on both housing market trends and the economy at large. Unemployment is tightening at an above-average rate for younger workers, however, creating some potential upside for household formation and consumption growth in the years ahead.

Generally tepid global growth and fluctuations in interest rates and currencies are influencing U.S. growth. Much as uncertainty has kept U.S. consumers and businesses cautious, other countries are dealing with major economic, social, and geopolitical issues including:

—China's slower expansion
—Low commodity prices
—Rising populist/nationalist sentiment (culminating in both the BREXIT vote and, to some extent, the Trump election)
—Terrorism and military conflict

2.5 DOLLAR CONTINUES TO RISE VERSUS OTHER MAJOR CURRENCIES



SOURCES: U.S. FEDERAL RESERVE BOARD, BENTALL KENNEDY; NOTE: 7-DAY MOVING AVERAGE, DATA AS OF 12/16/16

Trump's policies could upend the "Goldilocks" U.S. growth story we observed in Perspective a year ago.

In this climate the U.S. is attracting investor capital, driving up the value of the dollar relative to other currencies.

The interplay of various global events and their impact on the U.S. economy is admittedly not easy to parse out, particularly with the Trump election. A strong dollar is hurting U.S. manufacturing activity by making U.S. goods more expensive on the global market, yet it is also enhancing the buying-power of U.S. businesses and consumers. Overall the implications of the global environment on the U.S. would seem to be disinflationary, but a tight labour market, stabilizing energy prices, and rising healthcare costs are all pushing inflation measures closer to the Fed's target—prompting its December 2016 rate hike.

Expectations for faster U.S. inflation and growth in the short run under a Trump administration coupled with the outlook for higher interest rates have, at least temporarily, invigorated the stock market and sent government bond yields higher. In December 2016 the 10-year Treasury rate was 2.5%, after dropping below 1.4% in June 2016. Major stock indices also reached record high levels in November. The Fed's rate hike in December 2016 will likely trigger additional inflows of foreign capital and boost the value of the dollar. Rising stock prices and expectations for a more favorable regulatory environment could put an end to flagging business investment in 2017. But, admittedly, this situation could play out in a myriad of ways.

The markets seem to be cheering a Trump presidency, due to expectations for:

—Reduced regulation
—Lower taxes
—Increased oil and gas exploration
—Potential for repatriation of dollars held abroad by U.S. corporations
—Additional military spending
—Investment in infrastructure

2.5%

10-YEAR TREASURY BOND YIELD, DECEMBER, 2016, UP FROM 1.4% IN JUNE, 2016

Yet there are clearly risks as well. Trump's policies could upend the "Goldilocks" U.S. growth story we observed in Perspective a year ago, triggering faster growth in the short-to-medium term, but leading to medium-to-long term imbalances that could be the catalysts for a recession. Specific downside risks include:

—Growing federal deficits
—Trade wars
—Regulatory changes that encourage financial risk-taking or harm the environment
—Escalating geopolitical conflict
—Immigration policy impacting availability of both skilled and unskilled labour

Some of these economic potholes will be hard to predict and may not materialize, but they will be important areas to monitor in the year ahead and beyond.

The U.S. economy is fundamentally sound and the potential for stronger GDP growth in 2017 is significant. Household incomes are rising, a trend that should continue as unemployment remains low. Personal savings is relatively elevated and consumer confidence, while far from exuberant, appears solid. Importantly, the earnings recession that afflicted U.S. companies in the first half of 2016 seemed to abate in the third quarter of the year. A solid fourth quarter could drive firms to invest, hire, and lease real estate more aggressively in 2017. Real GDP growth is likely to close 2016 below 2.0%. Faster growth is forecasted for 2017, with Moody's projecting a 2.8% growth rate. We are in general agreement with this outlook and the rate would be ahead of solid annual averages reported during 2014–15.

Canadian Economy: Canada struggles to get back on track

Largely due to the collapse in global energy and commodity prices, the Canadian economy has been experiencing sluggish growth of no better than 1% over the past two years. Modest growth has also translated into modest job gains, with the unemployment rate holding near 7% over much of this time.

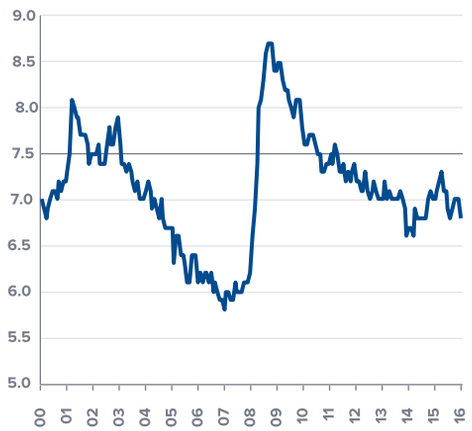
While oil-producing provinces have taken the brunt of the economic fallout resulting in a sharp regional economic divide in Canada, overall business investment was lacklustre in 2016—even in non-commodity sectors and regions. The eagerly anticipated rotation of growth drivers discussed in last year's Perspective were slow to gain traction. Consequently, the Canadian economy relied once more on housing activity and consumer spending to drive growth in 2016, causing further imbalances in these sectors. Fortunately, commodity prices appear to have stabilized. As long as trade policy does not materially change south of the border, the economic rotation process favouring exports should pick up momentum in the year ahead. This, together with federal fiscal stimulus plans, suggests that economic growth in Canada should improve closer to 2% in 2017, placing it more on a par with growth rates expected in the U.S.

EXPECTING MORE FROM TRADE

As a relatively small and open economy, exports account for nearly a third of Canadian GDP. This makes exports a potentially considerable driver of overall Canadian growth. Given that much of its trade is with the U.S., the weaker CAD/USD exchange rate in recent years—in conjunction with firming U.S. growth—theoretically should have resulted in materially better Canadian trade performance and stronger economic growth. There are a number of reasons why this did not occur. The first, and perhaps most obvious, is the significant downturn in Canadian energy sales—reflecting not just weak oil prices, but also the shutdown of energy production in the wake of the northern Alberta wildfires early last year. Recent agreements to cut production by both the Organization of the Petroleum Exporting Countries (OPEC) and some non-OPEC nations have pushed oil prices

2.6 REAL GDP GROWTH IN CANADA

2.7 CANADA'S UNEMPLOYMENT RATE



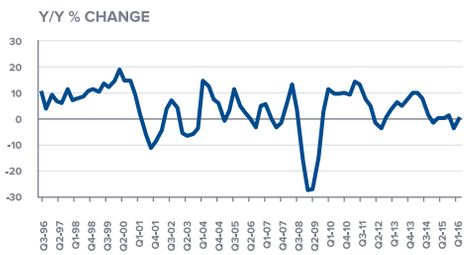
SOURCE: STATISTICS CANADA, HAVER ANALYTICS

As the anticipated rotation of growth drivers were slow to gain traction; the Canadian economy relied on housing activity and consumer spending.

Canadian trade should get a modest boost from the energy sector in 2017.

above $50/barrel—a level that should be profitable for some larger Canadian oil producers. Consensus forecasts are for oil to trade in the $50-$60/barrel range through 2017. With most oil sands facilities coming back on line following the recovery from the wildfires, Canadian trade should get a modest boost from the energy sector in 2017—the first positive contribution from this important sector in almost three years. While this suggests that the worst of the oil-shock may be over for energy-dependent provinces like Alberta, a return to the booming conditions of the last decade remains elusive. Somewhat more surprising has been the failure of non-commodity exports to respond to the stimulative drivers of a weaker C$ and stronger U.S. demand. One explanation for this is that much of recent U.S. growth is being driven by household spending. This component tends to have a lower Canadian import content compared to areas like U.S. business investment. In addition, developing weakness in global demand for U.S. exports may have reduced demand for Canadian-sourced intermediate production inputs. The recent slowdown of global trade activity—and a potential ebbing of the secular process of integrating global supply chains that accelerated a decade ago—may have also begun to affect Canadian trade volumes.

2.8 CANADIAN REAL EXPORT GROWTH



SOURCE: STATISTICS CANADA, HAVER ANALYTICS

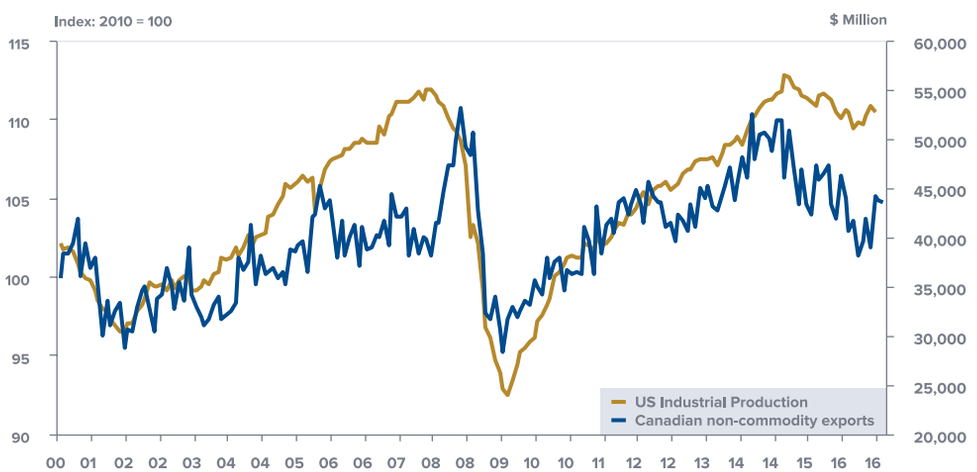
UNCERTAINTY IN THE U.S.

Nevertheless, we continue to anticipate that stronger industrial production stateside, in tandem with a material improvement in U.S. business investment, should ultimately translate into much better growth prospects for Canadian non-commodity exports in 2017. This is especially likely as the loonie could modestly weaken a bit further in 2017 as the Bank of Canada remains sidelined relative to the Fed.

The new incoming U.S. President and his administration's plan to significantly boost U.S. infrastructure investment could also have positive knock-on effects for Canadian trade, since a large component of materials typically used in such spending tends to be imported from Canada. That said, potential policy changes by the new U.S. administration could also pose a major downside risk to the Canadian trade sector. Significant rhetoric during the U.S. election campaign was directed at "tearing up" the existing North American Free Trade Agreement (NAFTA) and replacing it with something that makes access to the U.S. more difficult for foreign countries. Such protectionist sentiment has also been heard from other important Canadian trade partners and appears to largely be a nationalist backlash against the rise of globalization over the last two decades.

Any significant impediment to trade (and capital) flows from the U.S. or other major trading partners would not only have negative repercussions for Canadian trade; it could also significantly impair the real estate sector and industrial property demand throughout Canada. Indeed, globalization and the integration of global supply chains has been a major factor behind the growth of distribution activity in Canada's industrial market. As such, real estate investors should closely monitor how global trade discussions unfold in the months ahead.

2.9 CANADIAN NON-COMMODITY EXPORTS AND US INDUSTRIAL PRODUCTION



SOURCE: STATISTICS CANADA, HAVER ANALYTICS

The biggest factor driving the housing market, however, has arguably been the incentive of rock-bottom mortgage rates and the wide availability of credit.

The biggest factor driving the housing market, however, has arguably been the incentive of rock-bottom mortgage rates and the wide availability of credit, given Canada's sturdy financial market. However, increasing household sector imbalances have continued to cause unease among policy makers; debt-to-income levels continue to reach new highs, and affordability significantly stretched due to record-high house prices (mainly in Vancouver and Toronto). In order to address the excesses, Canada's federal government introduced measures in 2016 to make more stringent and uniform qualifying rules for mortgage insurance across all mortgage types.

In BC, provincial/municipal measures were also introduced to stem foreign buying (ie., an additional 15% property transfer tax on foreign nationals, corporations, and trusts who purchase in Metro Vancouver). Given very tight rental vacancy rates in Greater Vancouver and rising market rents, local officials also introduced a vacancy tax for the city of Vancouver targeted at absentee owners. This was aimed largely to address the lack of supply in rental units and deteriorating rental affordability—which officials also partly attribute to significant foreign investment.

While the long-term impact of these policy measures are difficult to quantify, a gradual softening in overall housing-ownership demand and a commensurate strengthening in rental demand remains the consensus forecast going forward—especially in the unaffordable markets of Toronto and Vancouver.

HOUSING TO THE RESCUE AGAIN

Amidst the weakness of the external side of its economy, Canada's housing market maintained solid momentum for much of 2016:

- Conditions were especially hot in Vancouver and Toronto
- Even oil-ravaged markets in Calgary and Edmonton saw better than forecasted sales activity during the year
- Residential investment, whose contribution to the economy is now at record levels, also helped power growth in housing-related purchases

Canada's strong residential market has been driven by robust immigration—a powerful, fundamental driver of long-term housing demand. Comparatively, strong employment growth in such high-paying sectors as healthcare and technology have also contributed to activity—specifically in Toronto and Vancouver. Robust foreign demand for high-end properties in these two "global cities" has also played an important role at the margin.

2.10 SHARE OF RESIDENTIAL IN THE CANADIAN ECONOMY

SOURCE: STATISTICS CANADA, HAVER ANALYTICS

$0.75

WIDENING U.S.-CANADA INTEREST RATE DIFFERENTIALS COULD PUT FURTHER MODEST DOWNWARD PRESSURE ON THE LOONIE, CAUSING THE EXCHANGE RATE TO WEAKEN TO JUST BELOW 75 U.S. CENTS.

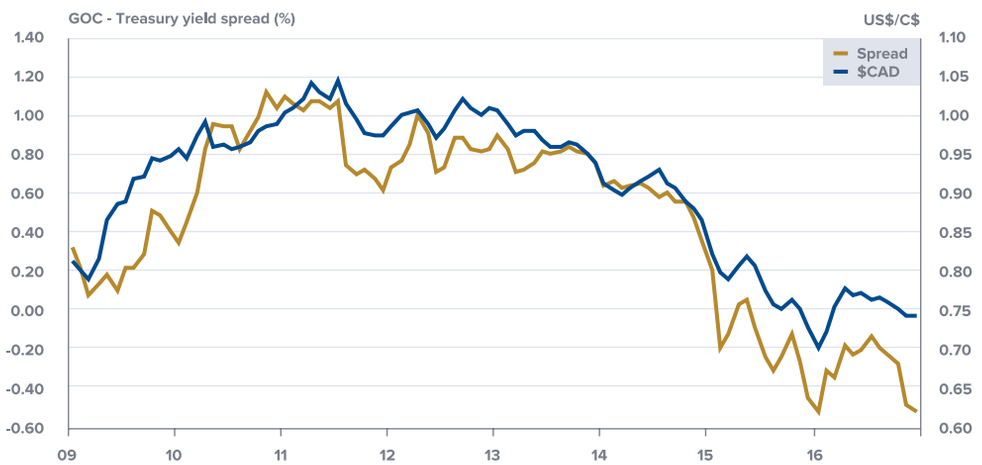
POLICY TRANSPARENCY IN CANADA

Despite tighter mortgage rules, the overall policy environment in Canada remains highly stimulative and will continue to play a supportive role for growth over the forecast horizon. On the monetary side, the Bank of Canada has indicated that it will remain firmly on the sidelines and keep interest rates at historical lows to help the rotation of growth drivers. With the Fed continuing to gradually hike rates, widening U.S.-Canada interest rate differentials could put further modest downward pressure on the loonie, causing the exchange rate to weaken to just below 75 U.S. cents.

On the fiscal side, the federal government has promised to ramp up support to the economy through increased household transfers and infrastructure spending. Given the time it takes for government outlays to translate into shovels in the ground, the bulk of the growth impetus is likely to occur in late-2017 and 2018.

It should be noted that the policy environment described above remains highly transparent and makes a major contribution to Canada's investment environment. Indeed, investors should appreciate that the economic, fiscal, political, and social policy environment makes Canada an extremely attractive place to do business, and a stable place to invest global capital.

2.11 2 YR US/CANADA GOVERNMENT BOND SPREAD & CAD



SOURCE: HAVER ANALYTICS

Investors should appreciate that the economic, fiscal, political, and social policy environment makes Canada an extremely attractive place to do business, and a stable place to invest global capital.

Bentall 5
Vancouver, BC

Real Estate and Capital Markets

TRENDS

—Canadian direct equity real estate returns have been mean reverting in recent years, while the Canadian REITs and equity markets had a remarkable bounce-back year in 2016.
—The U.S. Fed has raised interest rates for the second time since the end of the recession. Long-term rates are on the rise in both the U.S. and Canada.
—Regional divergences in economic growth, property fundamentals, cap rates, and ultimately investment performance are anticipated to continue into 2017.

TRANSACTION ACTIVITY

—2016 will likely record the highest transaction volume since 2007, surpassing $35 billion.
—There is an insatiable appetite for high-quality real estate from both domestic investors and, increasingly, foreign capital.

LENDING

—Access to inexpensive debt capital remains plentiful in most markets for high-quality assets.
—Lenders are re-thinking their strategies and exposure levels in Alberta where property fundamentals continue to deteriorate.

VALUES & PERFORMANCE

—Cap rates over risk free rates remain historically wide, providing a cushion to absorb rising interest rates, helping to preserve capital values.
—Future returns are expected to become income oriented, enhanced with capital appreciation driven predominantly by modest NOI growth.

Bentall Kennedy

Real Estate and Capital Markets: Insatiable appetite for high quality real estate

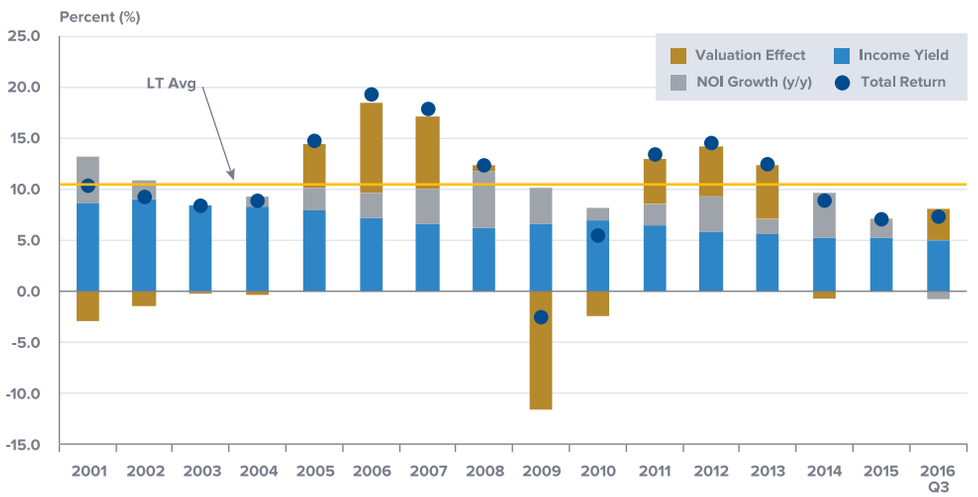
REAL ESTATE PERFORMANCE

The REALPAC/IPD Canada Property Index for standing investments posted a 7.4% total return for the twelve-month period ending Q3 2016, with 5.0% generated from income and 2.3% from capital appreciation. As we enter the late innings of the cycle, the total return has fallen behind the IPD ten-year average of 9.8%, largely due to deteriorating property fundamentals in Alberta. Negative net operating income (NOI) growth was more than offset by further cap rate compression, predominantly in Toronto and Vancouver.

In comparison, the NCREIF NPI index (U.S. counterpart) recorded a 9.2% total return over the same period, marking the third year in a row that the U.S. has outperformed Canada. Income returns continued to be enhanced by above-average (but decelerating) capital appreciation, predominantly in core office and industrial markets.

Meanwhile after a disappointing 2015, the S&P/TSX Index came roaring back in 2016—posting a total return of 21.1%. Although corporate profits were down year-over-year, multiples have expanded with basic materials, energy, and financial leading the way as commodity prices stabilized through the year.

3.1 DECOMPOSITION OF IPD CANADA TOTAL RETURN



SOURCE: MSCI REALPAC/IPD CANADA PROPERTY INDEX, TWELVE MONTH TRAILING RETURNS ENDING Q3 2016

Similarly, after a posting a loss of 4.6% in 2015, the public REIT market has bounced back with the S&P TSX REIT Index—registering a 17.6% total return in 2016. Outperformance can be attributed to:

—Relatively healthy property fundamentals
—Strong demand from new investors ahead of the September creation of an 11th Global Industry Classification Standard (GICS) sector for real estate
—The continuation of low 10-year bond yields

7.4%

TOTAL RETURN, MSCI REALPAC/IPD CANADA PROPERTY INDEX, TWELVE-MONTH PERIOD ENDING Q3 2016

$35b

FULL-YEAR 2016 TRANSACTION VOLUME FORECAST; CBRE

REAL ESTATE OUTPERFORMS ALL ASSET CLASSES OVER THE LONG TERM

Despite the recent relative underperformance, direct equity real estate has outperformed all other Canadian asset classes including bonds, Canadian equities, and REITs on both an absolute and risk-adjusted basis over a 10-year horizon.

In the current environment, cap rates over risk free rates remain historically wide, providing a cushion to absorb rising interest rates, helping to preserve capital values.

TORONTO AND VANCOUVER OUTPERFORM

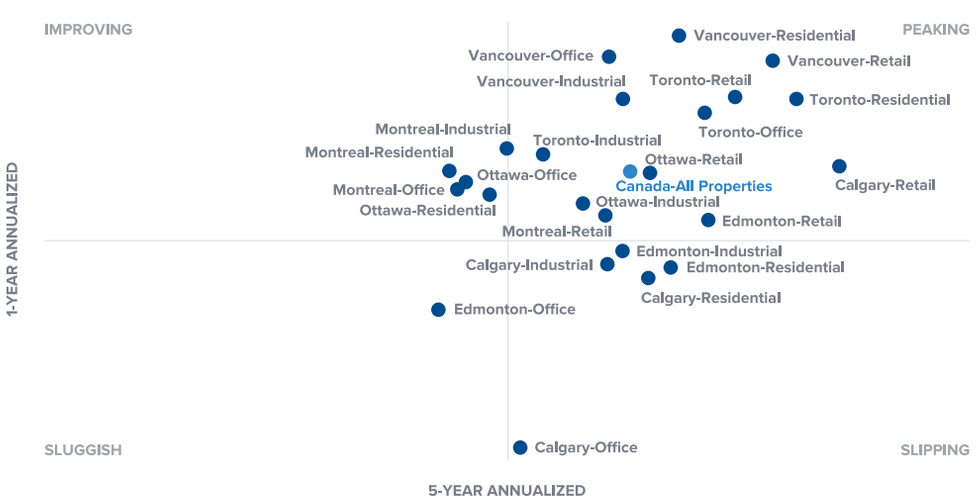
Toronto and Vancouver have been the top-performing regions this year with all but one sector outperforming. In contrast, Edmonton and Calgary have experienced declining returns since the third quarter of 2014 due to the downturn in the energy markets. Exacerbating the economic headwinds in Alberta is the imbalance in each of the downtown office sectors caused by a glut of new supply recently delivered and still remaining in the pipeline. While modest decompression in cap rates has occurred from an increase in required risk premium, vacancy rates have skyrocketed, eroding NOI and future on net effective rent expectations.

Vast regional economic differences are largely responsible for the divergence in returns this year as Vancouver and Toronto are expected to lead all CMAs this year in GDP growth at 4.0% and 3.4%, respectively. Household and consumer driven property types such as residential and retail were the top performing sectors, producing strong capital appreciation relative to the office and industrial sectors which were weighed down by deteriorating markets in Alberta.

INCOME ORIENTED FUTURE RETURNS

Capital appreciation has been declining in recent years due to decelerating yield compression. Nonetheless, the weight of capital continues to exert downward pressure on cap rates while NOI growth has turned negative, driven by softening fundamentals in the office sector. As this cycle becomes long in the tooth, future returns are expected to become dominated mostly by income, with capital appreciation anticipated to keep pace with inflation.

3.2 CANADA - TOTAL RETURNS, 1-YEAR VS 5-YEAR



SOURCE: MSCI REALPAC/IPD

30%

OVERALL FOREIGN INVESTMENT WELL ABOVE AVERAGE, DRIVEN BY CHINESE AND EUROPEAN CAPITAL

RECORD YEAR FOR TRANSACTION VOLUMES

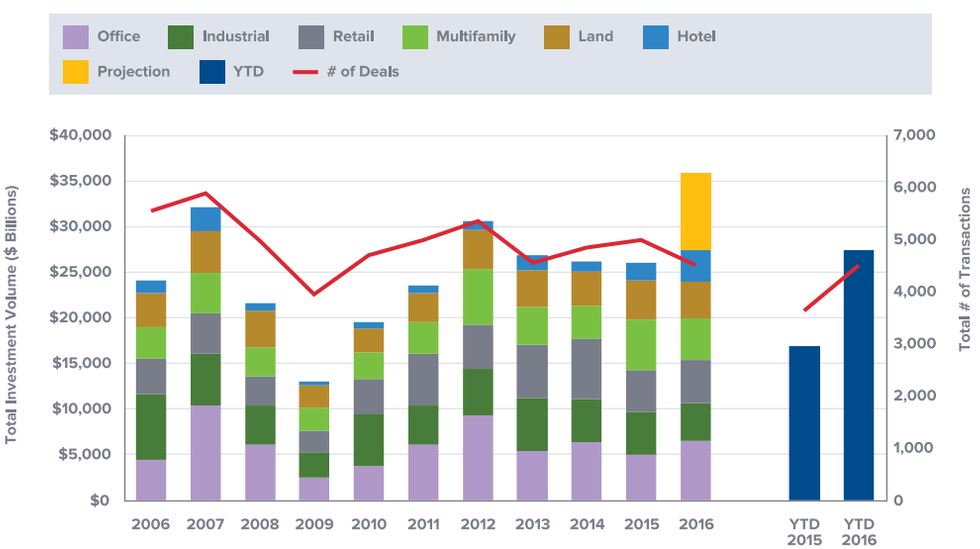
2016 is poised to record the highest transaction volume recorded since 2007 ($32.1 Billion) with capital flows reaching $27.4 billion at the end of the third quarter. According to CBRE, with a full-quarter of activity still remaining, the full-year forecast is anticipated to exceed $35 billion.

The availability of debt capital and record-low interest rates continued to fuel investors' insatiable demand for real estate. While the impact of foreign capital garnered the majority of the headlines in 2016, traditional domestic buyers remained the dominant players—accounting for 70% of the overall transaction volume.

Foreign investment in Canadian real estate this year was a significant factor, contributing to some eye-popping prices paid to acquire trophy assets in Toronto and Vancouver. Overall foreign investment (driven largely by Chinese and European capital) accounted for 30% of overall transaction volume, up six-fold from the long-run average of 5%. Foreign investment is now on par with private Canadian investors as the top two sources of investment capital.

Even with REIT values increasing throughout the year, lowering their cost of equity capital, REIT activity remained subdued, well below the historical average. The REIT sector continues to evolve towards more organic growth, along with an increased focus on development as opposed to the aggressive acquisition strategies of the past. Institutional investors are also finding it difficult to place capital prudently within the current pricing environment—and as a result have also been allocating capital toward development opportunities where returns are enhanced by delivering new product at pricing well above the cost of new construction.

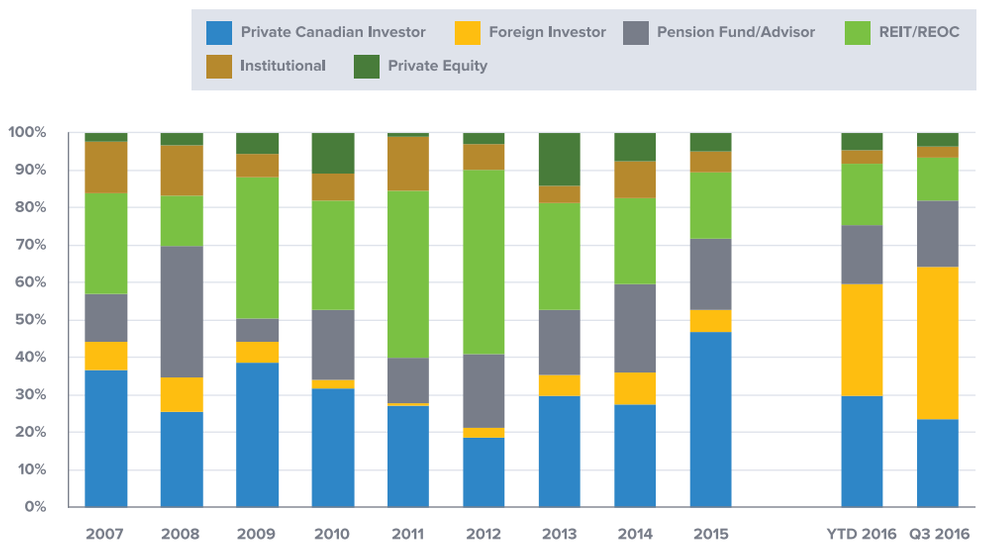
3.3 CANADIAN REAL ESTATE VOLUMES *



SOURCE: CBRE RESEARCH, REALNET CANADA INC., REALTRACK, COLLETTE PLANTE, JLR LAND TITLES, SOLUTIONS, Q3 2016; * TRANSACTIONS OVER $10MM

Office and retail properties are indicating signs of select cap rate decompression on weakening property fundamentals; conversely, strong tailwinds in the multifamily and industrial sectors are exerting downward pressure on yields

3.4 CANADIAN REAL ESTATE VOLUMES BY PURCHASER *



SOURCE: CBRE RESEARCH, REALNET CANADA INC., REALTRACK, COLLETTE PLANTE, JLR LAND TITLES, SOLUTIONS, Q3 2016; *TRANSACTIONS OVER $10MM

GLOBAL CAPITAL INFLOWS TO PERSIST

Foreign investment into Canadian real estate is anticipated to continue as part of a larger trend of capital inflows to North America; this is driven largely by Chinese, European, and Middle-East investors continuing to build global real estate portfolios in an effort to diversify across asset classes and within real estate. In addition to increasing global asset allocations, North American gateway cities (increasingly those within Canada) are considered a safe-haven for capital—due to the enhanced liquidity these markets offer as result of their transparency and stability of political and financial systems.

A recent Preqin global institutional investor outlook on alternative assets indicated that:

- Despite frothy asset pricing and difficulty finding investment opportunities, the overwhelming majority of investment managers are planning on meeting or increasing their current allocation targets to real estate over the next twelve months
- In order to gain access to high-quality assets for risk mitigation benefits that would otherwise be unattainable, co-investing was cited as a vehicle in which fund managers planned to allocate more capital
- Generally, global investors are looking to invest in core-plus and value-add strategies in gateway markets where there is greater liquidity

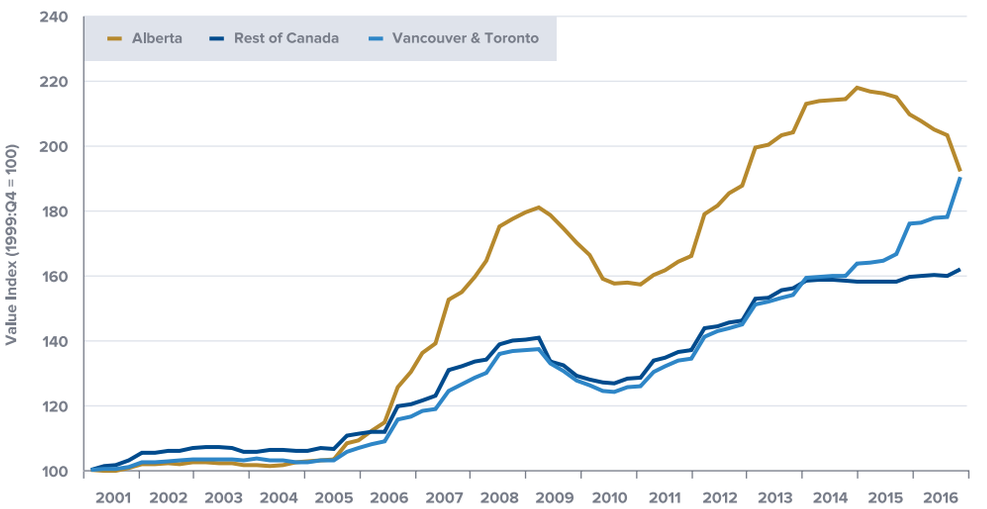
VALUATIONS DIVERGE WITH CAP RATE TRIFURCATION

Canadian real estate values have exceeded levels reached prior to the global financial crisis. However, recent regional economic divergence has influenced property fundamentals and capital flows differently across the country as previously discussed. On a sector basis, office and retail properties are indicating signs of select cap rate decompression on weakening property fundamentals. Conversely, strong tailwinds in the multifamily and industrial sectors are exerting further downward pressure on yields, to new lows in the Canadian market.

As averages can be misleading, it's important to look beyond the headlines:

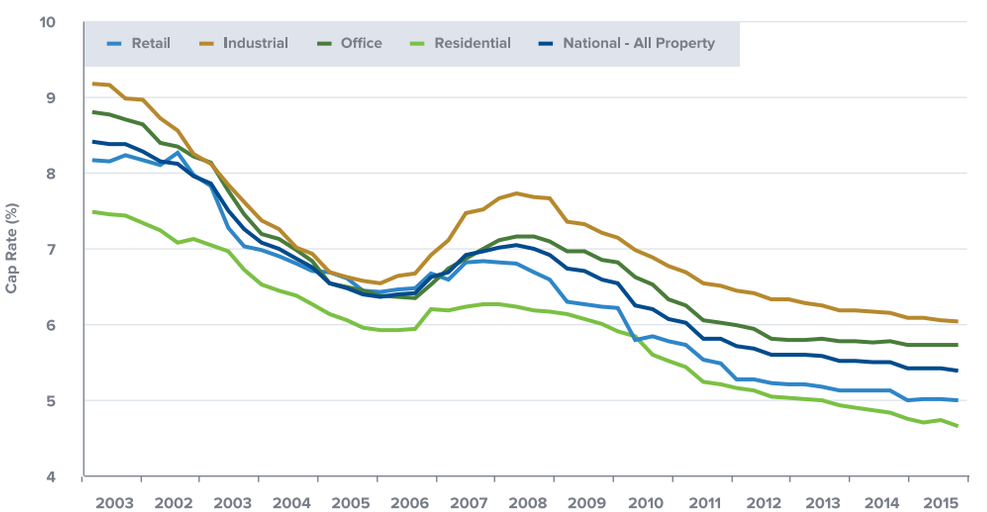
—Cap rates for office assets in Toronto and Vancouver continue to trend lower to new records, and now resemble yields for trophy assets in global cities such as New York, London, and Tokyo
—This pricing level is generally only achievable on the best-in-class assets with strong tenant credit and lease terms
—In Vancouver, high land values and speculative future redevelopment density are pushing cap rates lower than would be expected based on property fundamentals
—Additionally, the multifamily residential sector has experienced significant cap rate compression—particularly in urban areas of Toronto and Vancouver—based on the prospect of future rent growth as housing affordability, constrained housing supply, and robust immigration combine to form strong tailwinds

3.5 CANADIAN PROPERTY VALUES BY REGION



SOURCE: MSCI REALPAC/IPD

3.6 CAP RATES BY PROPERTY TYPE



SOURCE: MSCI REALPAC/IPD

3.7 COMMERCIAL MORTGAGES

COMMERCIAL MORTGAGE HOLDINGS BY TYPE OF HOLDER ($BILLIONS), AS AT MAY 2016

	2014	2016	CHANGE
CHARTERED BANKS	39.2	57.8	47%
CREDIT UNIONS	31.5	36.0	14%
LIFE INSURANCE COMPANIES	26.2	26.4	1%
NHA MBS MULTI-FAMILY	21.5	27.6	28%
TRUSTS AND OTHER INSTITUTIONS	9.1	12.3	35%
CMBS	8.9	7.2	-19%
PENSION FUNDS	8.5	10.6	25%
TOTAL	144.9	177.3	23%

MARKET SHARE BY HOLDER

	2014	2016	CHANGE
CHARTERED BANKS	27%	33%	5%
CREDIT UNIONS	22%	20%	-2%
LIFE INSURANCE COMPANIES	18%	15%	-3%
NHA MBS MULTI-FAMILY	15%	16%	1%
TRUSTS AND OTHER INSTITUTIONS	6%	7%	1%
CMBS	6%	4%	-2%
PENSION FUNDS	6%	6%	0%

SOURCE: REALPAC, STATISTICS CANADA, DBRS, CMHC

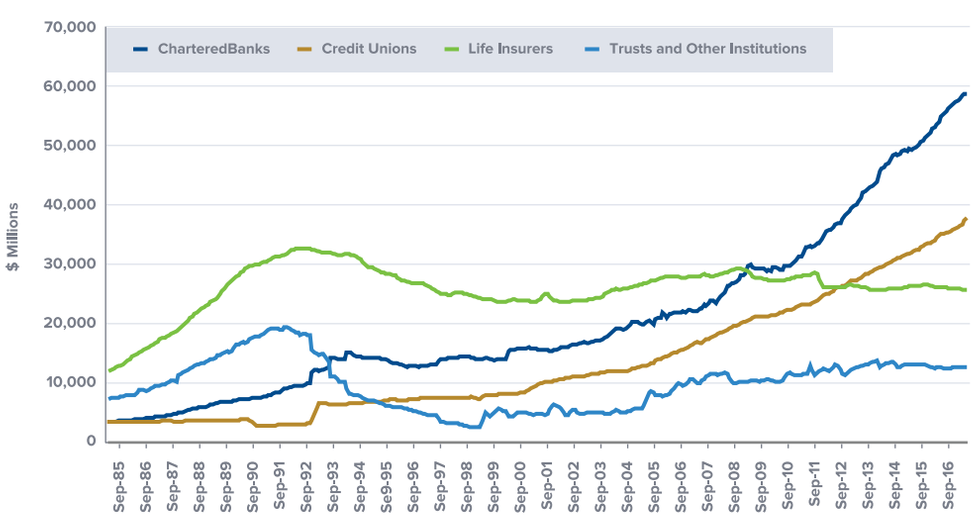
Increased risk premiums in the Calgary and Edmonton office markets have exerted upward pressure on cap rates, eroding valuations which had already been collapsing due to lower occupancy levels and market rental rates. For the most part, there hasn't been any significant cap rate decompression in either the retail or industrial sectors in Alberta as property fundamentals have held up relatively well. Cap rates in the multifamily sectors have held steady despite increased vacancy and NOI erosion, which has been sufficient in reducing values. Furthermore, demand persists as many investors pursue increased allocations to the multifamily sector, particularly in Calgary where it has been historically difficult to gain a foothold in the market.

DEBT CAPITAL REMAINS PLENTIFUL

In this low interest rate environment, real estate has been able to deliver enhanced returns through the use of positive leverage. The availability of debt capital is an important influence on capital flow, the direction of cap rates, and, consequently, values. In recent years, debt capital has been plentiful and available at record low costs with long term interest rates at historic lows.

Bond yields increased dramatically following the U.S. election in early November.

3.8 COMMERCIAL MORTGAGE HOLDINGS BY SELECTED FINANCIAL INSTITUTIONS FROM 1985 TO 2016



SOURCE: REALPAC, STATISTICS CANADA, DBRS, CMHC

3.9 NEGATIVE RATE CONTAGION

BOND YIELDS IN EUROPE, JAPAN, AND NORTH AMERICA (AS OF 12/31/16)

COUNTRY	1-YEAR	2-YEAR	3-YEAR	4-YEAR	5-YEAR	6-YEAR	7-YEAR	8-YEAR	9-YEAR	10-YEAR
SWITZERLAND	-0.94	-0.96	-0.89	-0.76	-0.67	-0.56	-0.48	-0.35	-0.29	-0.19
JAPAN	-0.27	-0.18	-0.16	-0.12	-0.11	-0.08	-0.06	-0.02	0.01	0.05
GERMANY	-0.80	-0.77	-0.78	-0.68	-0.53	-0.39	-0.27	-0.14	0.01	0.21
NETHERLANDS	-0.86	-0.74	-0.71	-0.65	-0.37	-0.33	-0.17	0.02	0.21	0.36
FINLAND	-0.71	-0.64	-0.62	-0.53	-0.46	-0.27	-0.04	0.02	0.24	0.35
AUSTRIA	-0.63	-0.65	-0.63	-0.49	-0.36	-0.18	-0.10	0.10	0.25	0.43
FRANCE	-0.74	-0.66	-0.50	-0.31	-0.12	-0.08	0.06	0.26	0.52	0.69
BELGIUM	-0.69	-0.67	-0.62	-0.55	-0.40	-0.23	-0.12	0.15	0.37	0.53
SWEDEN	-0.84	-0.62	-	-0.38	-0.11	-	0.13	0.34	-	0.56
DENMARK	-	-0.54	-	-	-0.27	-	-	0.04	-	0.33
IRELAND	-0.66	-0.55	-0.54	-0.46	-	-0.12	0.07	0.35	0.55	0.75
SPAIN	-0.35	-0.28	-0.19	0.06	0.27	0.64	0.82	1.08	1.26	1.38
ITALY	-0.28	-0.18	-0.06	0.23	0.60	0.89	1.19	1.43	1.56	1.82
UNITED STATES	0.81	1.19	1.45	-	1.93	-	2.25	-	-	2.44
UNITED KINGDOM	0.12	0.08	0.12	0.34	0.49	0.69	0.81	0.95	-	1.24
CANADA	0.63	0.75	0.84	1.00	1.11	-	1.40	-	-	1.72

SOURCE: BLOOMBERG

According to REALPAC:

—The size of the Canadian institutional commercial mortgage market increased to $177.9 billion in 2016, representing growth of 23% since 2014
—Chartered banks continue to increase their market share, now accounting for 33% of the overall market—up 500bps from 2014
—Credit unions and life insurance companies have been the second and third largest issuers of mortgage debt, respectively; however, each lost ground to the banks this past year in terms of market share

September of this year delivered an uptick in 10-year U.S. Treasuries on anticipation of the Fed raising interest rates in December. Bond yields increased dramatically following the U.S. election in early November and have remained elevated since. The exodus from bonds into other asset classes, notably stocks, was largely driven by the prospect of economic growth, higher interest rates, and inflation as a result of President-elect Trump's fiscal stimulus plan. As Canadian bond yields are highly correlated to U.S. yields, the Bank of Canada 10-yr rates increased as well, now yielding 1.7% as of December 30, 2016.

It is possible that the recent increase in interest rates may be short-lived as a number of indicators would suggest that bonds are oversold. Moreover, the larger secular trend of aging demographics is a force that cannot be stopped, and the investment income requirements and risk profile of this segment are likely to continue to exert downward pressure on rising rates.

Across the globe, institutional investors and pension funds remain hungry for yield to meet their increasing liabilities, namely the pensions of an aging population. Incredibly, at one point in 2016 over $13 trillion (an estimated 13%) of the total global bond market was yielding negative returns across maturities as long as 20 years. For these reasons, despite the Fed hike in December and guidance to hike further in 2017, it's unlikely that long-term rates will increase at the same rate. In Canada, the Bank of Canada is likely to sit on the sidelines until at least early 2018, as the near-term growth outlook isn't nearly as optimistic as south of the border. We anticipate that, while rates are likely to gradually move higher, "low for longer" remains the dominant theme.

Debt capital continues to be readily available in most markets for high quality assets. For lesser quality and/or secondary and tertiary markets, underwriting standards have tightened as lenders try to limit their risk exposure; however, overall availability does not seem to be an issue. On the other hand, in Alberta some lenders have pulled out altogether; while the majority of lending that is occurring is deal specific or based on long-standing relationships between borrows and lenders that have developed over a number of years. CMLS indicates that current commercial mortgage spreads on high-quality assets are currently being priced in the 185 to 210 bps range for 5-year deals, and 200 to 225bps for 10-year deals.

Debt capital continues to be readily available in most markets for high quality assets

According to a recent CBRE Canadian Real Estate Lenders Report:

- The majority of Canadian lenders are expecting to increase their allocation to commercial real estate next year with a flight to quality theme
- Lenders are generally looking for larger loan sizes with a preference for industrial or multifamily properties which have favourable property fundamentals
- In terms of geographic preference, Vancouver and a number of Ontario markets are desired where microeconomics are stronger and are becoming of greater importance in the underwriting process
- Lenders are willing to go as high as 75% maximum leverage on top-tier assets, while Class B properties and/or secondary markets generally command a 15-20bp spread premium to compensate for additional risk

121 King Street West
Toronto, ON

Sun Life Building
Montreal, QC

Space Market Trends 04

Office

TRENDS

—Most markets are entrenched in a "tenant favourable" stage as the national vacancy rate has surpassed 13% and rents softened as a result of weaker demand and a robust development pipeline.

DEMAND

—National figures mask vast regional differences. Strong demand from the tech sector is driving absorption in the Vancouver and Toronto markets while weakness continues in the energy-dependent markets of Calgary and Edmonton.

SUPPLY

—As a result of an active development cycle, supply continues to outweigh demand, particularly in Calgary and Edmonton and to a lesser extent, Montreal and Vancouver.

OUTLOOK

—Office demand should see a modest improvement in line with economic growth expectations in 2017. Overall, the level of new construction is anticipated to exert upward pressure on vacancy and weigh on market rents, but is unlikely to create any significant dislocation.

SUSTAINABILITY

—Employers are migrating to and expanding in the active urban nodes that offer the lifestyle desired by younger workers. Within these locales, firms are placing value on sustainable building features that align with their corporate values and also appeal to discerning employees. High-quality space and amenities help attract and retain the best talent.

Bentall Kennedy

Office: National vacancy exceeds long-term average

Demand fundamentals in the office market are largely shaped by the business cycle and its impact on office-using employment. On that score, the situation in Canada has been relatively modest:

—Office-using employment (which includes finance, insurance, commercial, and technology services) has been growing at a trend rate of 1-2% per annum since 2009 (just 600,000 people per year)
—This compares to a 3-4% annual growth rate prior to the recession
—A good part of recent sluggishness is associated with the commodity downturn—particularly in markets such as Calgary where a significant percentage of the office tenant base is directly employed by the energy sector

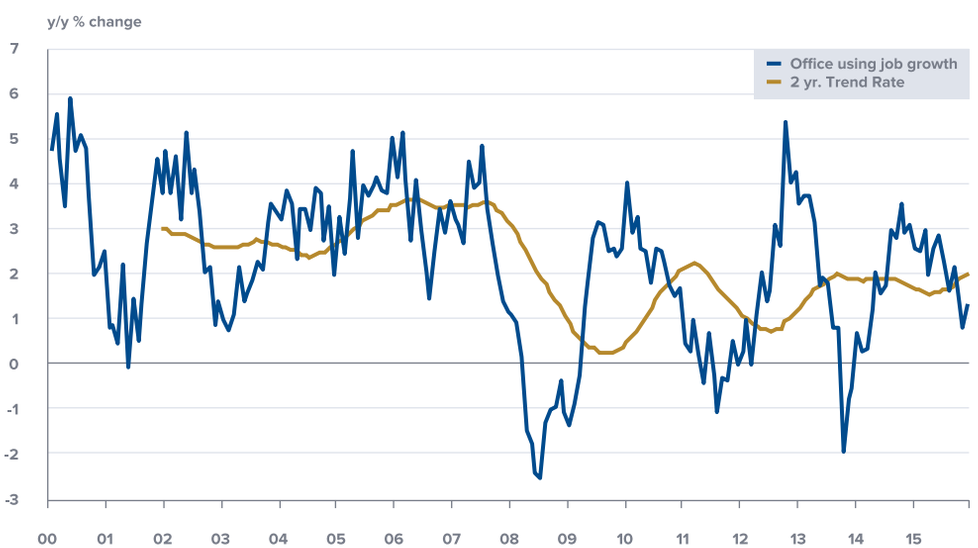
In addition, the commodity downturn has also indirectly slowed employment growth in other key office using sectors such as banking and finance, which has a high exposure to natural resources in Canada.

THE IMPORTANCE OF TECH

To be sure, some sectors such as technology have been growing at a much faster rate of about 3-5% over the past few years. The strong demand for "talent" in tech has largely motivated many firms in this sector to adopt workplace strategies that encourage flexibility and collabouration. This has certainly put tech at the leading edge of office utilization trends. Other industries are increasingly embracing the "tech model" of more flexible work space arrangements, improved workspace density, and health and wellness initiatives—not only to attract and retain employees, but to also improve operating costs.

The tech sector has been especially supportive to Vancouver and Toronto's office markets in recent years, consistent with tech's positive impact on a number of key U.S. office markets over this cycle. While it's been argued that the Canadian tech sector is generally smaller in absolute size compared to its U.S. counterpart, the relative weight or concentration of this sector in Toronto's office market (as measured by tech jobs per 1,000 sq. ft. of office space) is actually very similar to most American cities—while it is outsized in Vancouver. In fact, Vancouver is second in North America only to San Francisco in terms of the concentration of tech workers in its office market.

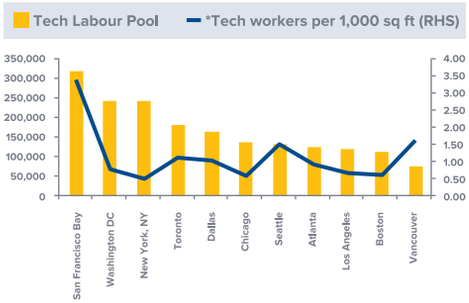
4.1 QUARTERLY OFFICE JOB GROWTH IN CANADA*



SOURCE: STATISTICS CANADA

Vancouver is second in North America only to San Francisco in terms of the concentration of tech workers in its office market.

4.2 TECH SECTOR EMPLOYMENT AND TECH OFFICE CONCENTRATION *

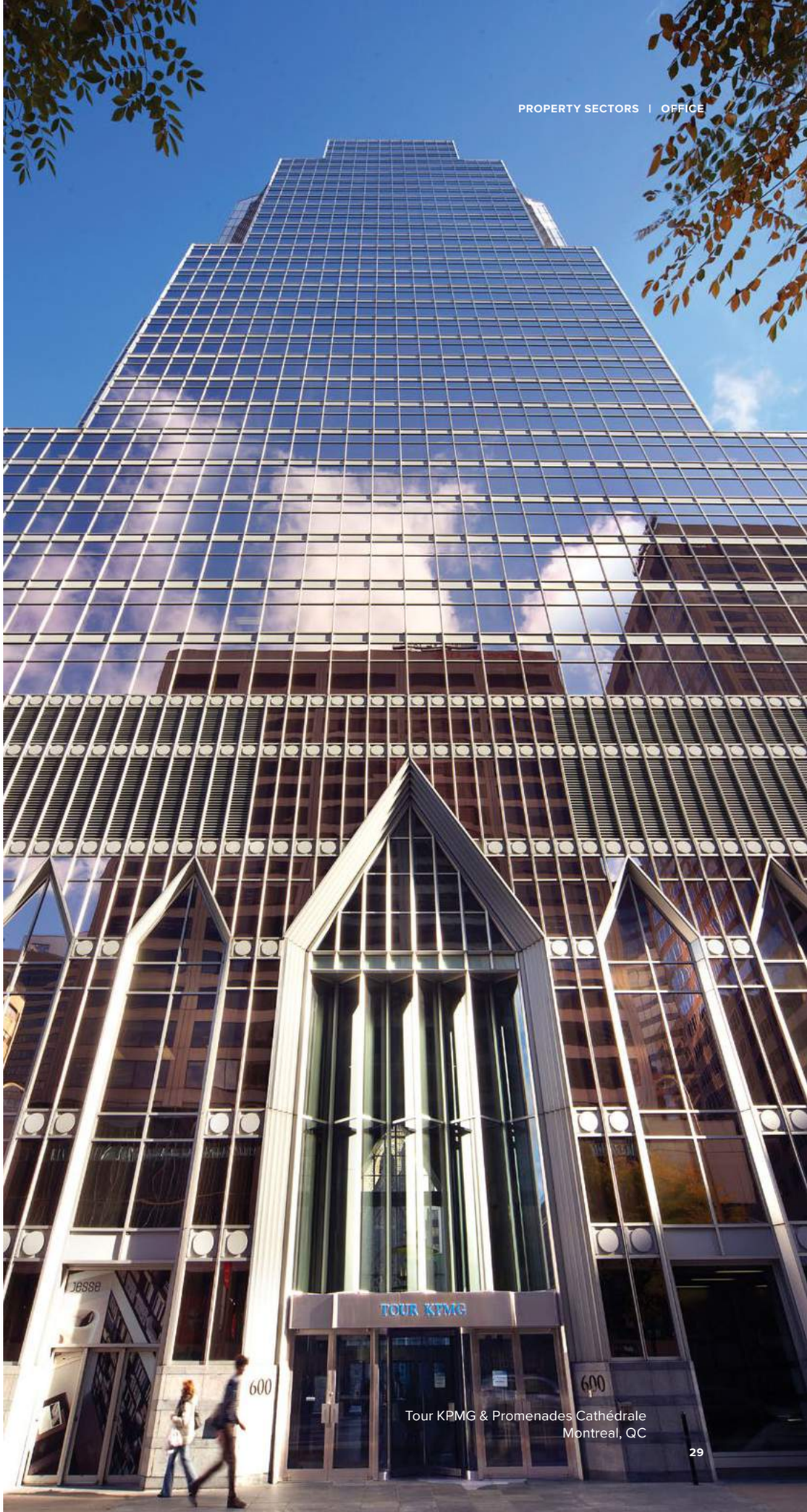


SOURCE: BLS, STATISTICS CANADA, BC GOVERNMENT; CBRE

FUNDAMENTALS CONTINUE TO SOFTEN

While the tech sector has been a bright spot, the soft picture of overall office demand was apparent in both the national suburban and downtown office markets over the past year. According to CBRE, national downtown office vacancy increased to 10.6% as of Q3 2016—an increase of over 400bps from 2012 when it was at its lowest point in this cycle. Meanwhile, national suburban office vacancy increased to 15.7%, about a 500bps increase from its lowest point this cycle.

Although downtown and suburban office vacancy tends to move in tandem (and this cycle has been no exception), average net rental rates in these segments do not necessarily move in synch and can often deviate depending on how far off each is from its own specific "equilibrium." To this end, the recent narrowing of spreads between downtown and suburban net rents suggests that downtown office vacancy may be moving further away from its equilibrium than suburban office as the cycle continues.



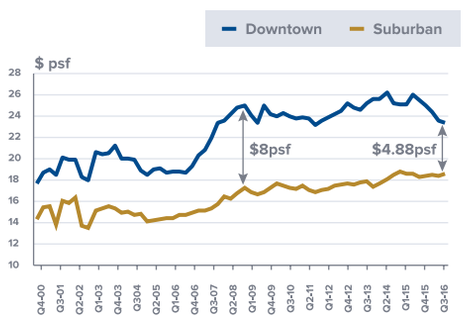
Tour KPMG & Promenades Cathédrale
Montreal, QC

While soft demand has played some role in pulling office markets out of equilibrium, the new supply pipeline is also a big factor. As the graph suggests, downtown markets will be the biggest recipient of new supply (both directly and as a percentage of relative market size). Most of this new space is being developed by conservative institutions that have generally adopted a strategy of core development given that pricing for existing product has become so expensive. Most of these new downtown developments are not speculative and have been pre-leased to existing tenants specifically looking for modern functionally efficient properties—but backfilling the older stock of buildings has been relatively slow since it is largely reliant on organic demand growth. This imbalance between supply and demand is the main factor behind the recent softening of downtown office rents as landlords aggressively compete for tenants.

NATIONAL FIGURES MASK DIVERGENT REGIONAL CONDITIONS

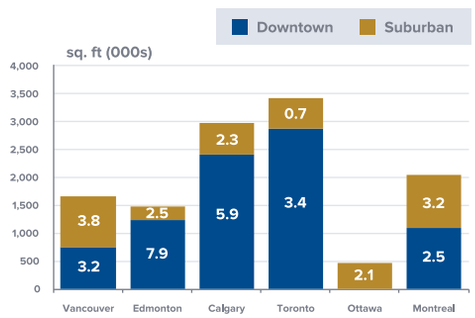
It should be noted, however, that the national vacancy numbers mask significant regional variation. For example, the energy-dependent office markets of Calgary and Edmonton are most out of balance, and the new supply pipeline is only expected to exacerbate those imbalances going forward. In addition, "ghost" or "shadow" vacancy along with tenant space rationalization will add to the lag time between the economic recovery and the recovery in the office market. As such, tenant inducements have been significant in these markets, with net effective rents (NERs) in Calgary effectively approaching zero. In sharp contrast, the office market remains exceptionally tight, specifically in downtown Toronto. While the city is in the midst of an active development cycle, continued intensification of its urban core and the continued desire of many office users to locate in distinctive urban office environments has kept demand for quality office space strong.

4.3 AVERAGE CLASS A NET RENTAL RATES



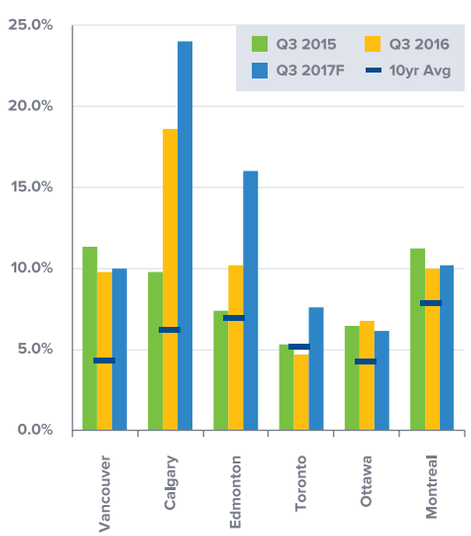
SOURCE: CBRE

4.4 OFFICE UNDER CONSTRUCTION* Q3 2016

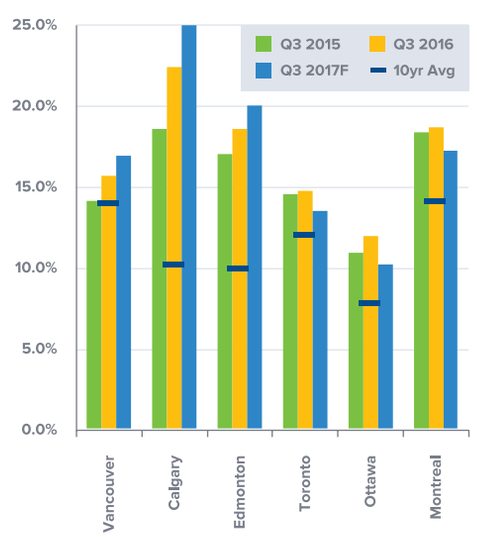


SOURCE: BLS, STATISTICS CANADA, BC GOVERNMENT; CBRE; * % OF INVENTORY

4.5 VACANCY TREND DOWNTOWN CLASS A OFFICE



4.6 VACANCY TREND SUBURBAN CLASS A OFFICE



SOURCE: CBRE, BENTALL KENNEDY

Space Market Trends

04

Edmonton Brewery District
Edmonton, AB

Retail

TRENDS

—Retail sales continue to grow at a moderating level; however, headwinds are emerging as leveraged consumers are likely to face increased debt servicing costs. Property fundamentals remain healthy for urban formats and super-regional malls while continued divergence is anticipated for secondary and tertiary markets and assets.

DEMAND

—Changing spending patterns, including increasing growth in ecommerce, rising demand for experiential retail offerings, and a growing concentration of sales in urban retail nodes are disrupting space demand.

SUPPLY

—New retail construction remains restrained as developers focused on new and redevelopment opportunities as part of urban mixed-use communities, while retailers allocate capital to building out their distribution networks to handle growing ecommerce volume.

OUTLOOK

—Changes in the retail market are more than cyclical as ecommerce grabs a larger and larger piece of activity with each passing year. The market will continue to reveal stark differences between winners and losers, even as retailers strive to employ omni-channel sales strategies to better compete with Amazon.

SUSTAINABILITY

—Urbanization has increased the demand for a broader selection of retail amenities within metro areas. Increasingly, retail strategies are playing an important part in the success of walkable, mixed-use urban neighborhoods.

Bentall Kennedy

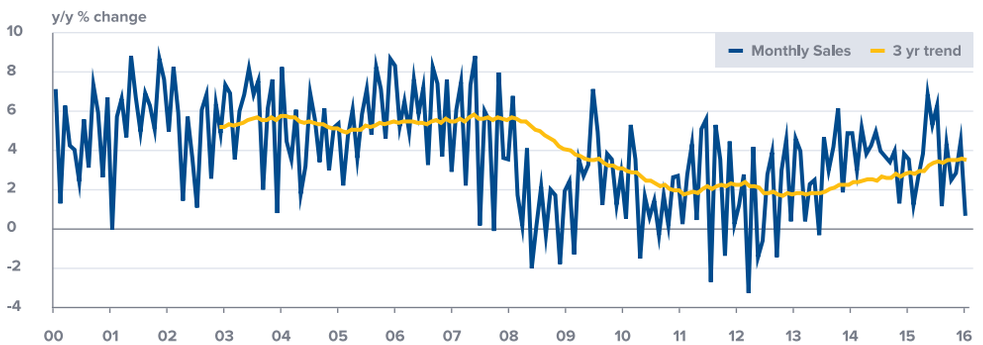
Retail: Maintaining footing on a shifting landscape

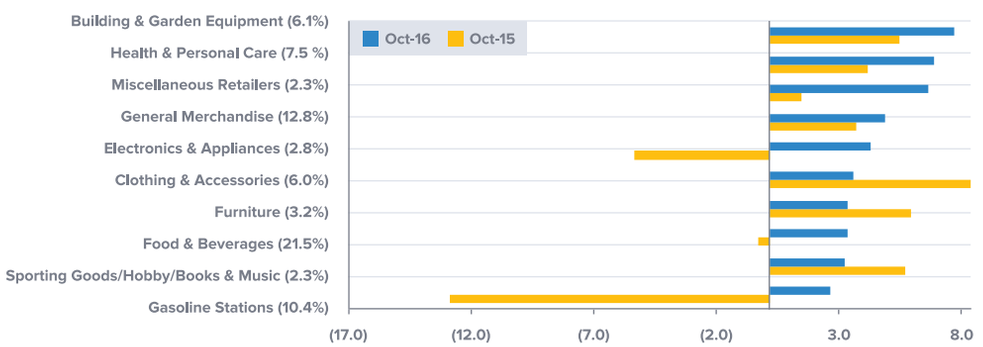
RETAIL SALES HEALTHY BUT HEADWINDS EMERGING

Core retail sales (excluding gasoline and automotive purchases) continue to grow, at moderating levels, supported by an increasingly debt-burdened consumer. Nonetheless, core retail sales are anticipated to finish the year at the fastest pace of growth since 2008—recording a 4.0% increase year-to-date through October 2016. Despite household debt levels reaching record highs at the end of the third quarter (167%, ratio of household debt to disposable income), consumers remain very well supported by ultra-low interest rates and robust housing price growth in major urban centres which are helping to bolster household balance sheets.
The health and personal care retail category has outperformed as consumers are exhibiting shifting preferences for "wellness," while home improvement has been buoyed by the overall strength in the housing market. Looking ahead, core retail sales growth is expected to remain positive but could see near-term deceleration in some parts of the country due partly to softer housing activity. House prices generally influence consumer spending through a direct housing wealth effect and a collateral effect. In other words, households spend more when they feel wealthier and they are able to access credit as the collateral value of their homes increases.

4.7 CORE* RETAIL SALES

SOURCE: STATISTICS CANADA; *EXCLUDES MOTOR VEHICLES AND GAS





4.8 RETAIL SALES BY CATEGORY AS OF OCT 2016

SOURCE: STATISTICS CANADA; *BRACKETS ARE SHARE OF TOTAL RETAIL SALES

However, the prospect for higher mortgage rates, further tightening in insured mortgage lending rules, and higher capital rules on financial institutions has the potential to increase the overall debt servicing costs for homeowners. This is likely to have a dampening effect on retail sales, as households reallocate discretionary income to debt service.

Top-line sales revenue among retailers has been assisted by a weaker Canadian dollar, as more Canadians stay north of the border to shop and more American tourists travel across the border. Additionally, there is less of a unique and differentiated experience when shopping in the U.S. than there has been historically with many U.S. and international retailers opening locations in Canada in recent years. Unfortunately for many retailers sourcing product from abroad, the low Canadian dollar has exerted downward pressure on gross margins forcing them to either raise prices or reduce operating costs in order to maintain profits.

MALL PRODUCTIVELY INCREASINGLY BIFURCATED

Relatively healthy core retail sales has not translated into the same pace of growth within shopping centres, as mall productivity is down year-over-year—although still increasing at a 2.6% pace through October 2016 (to $745 per square foot). However, shopping centre productivity is vastly differentiated among the top performing super-regional malls compared to the rest of the pack. Super-regional mall landlords have been proactive in recent years, spending money to upgrade and expand their centres in order to enhance the shopping experience and to create opportunities for new international retailers looking to expand or enter the Canadian market. Not surprisingly, Canada's 15 most productive malls experienced a 13.7% increase (to $1,157 per square foot) in sales from 2014 to 2015, while the next 85 most productive malls

13.7%

2015 YEAR-OVER-YEAR PRODUCTIVITY INCREASE IN THE 15 TOP-PERFORMING MALLS

experienced a sales increase of 6.7% (to $612 per square foot), according to Altus Data Solutions. If October year-to-date national mall productivity is any indication, further divergence between the "best" and the "rest" is anticipated for 2017.

ACCELERATING EVOLUTION OF RETAIL

There is no denying the accelerating pace of change occurring in today's retail environment; uncertainty around the sector has never been greater. Growth in ecommerce and shifting consumer preferences due to changing demographics are disrupting the retail landscape and creating challenges for retailers. To weather these challenges, most retailers are investing heavily in merging their online and offline supply chains, expanding ecommerce and m-commerce platforms, and adding digital features to attract millennial and generation z shoppers into physical stores. The pathway to purchase (steps a consumer takes to acquire a good or service) continues to evolve to an iterative omni-channel customer journey.

While it is highly unlikely that ecommerce will replace brick and mortar retail in its entirety, there is much uncertainty around the ultimate impact online retailing will have on the demand for physical retail space moving forward. According to recently released data by Statistics Canada:

—Online sales only amount to approximately 2.0% of total retail sales
—However, when food, auto and gasoline sales are excluded (the more appropriate comparable for non-food-anchored shopping centres), the figure is closer to the 4.0% that many experts had previously estimated it to be

E-commerce penetration is still significantly less than in other developed countries in Europe and the U.S.; however, online sales are growing at double-digit growth rates. This is more likely a function of retailers' lack of investment in e-commerce infrastructure as opposed to consumers' preferences/demand to purchase online. In other words, if online and mobile app purchasing was simplified and execution of same-day or next-day delivery was certain, then it's likely that there would be substantially higher e-commerce sales volumes. Given that Canada's internet penetration rate is one of the highest in the world, there appears to be a disconnect between shoppers' interest in purchasing online and retailers ability to execute the transaction. However, significant investments have been made this year by many of Canada's retail giants. For example:

—Hudson's Bay Company unveiled its new state-of-the-art robotic fulfillment system, spending more than $60 million to upgrade its Scarborough distribution centre to enhance its "all-channel strategy"
—Loblaw intends to expand its "click and collect" program to 100 stores by the end of 2016
—Walmart acquired web retail start-up Jet.com for $3.3 billion
—Canadian Tire replaced its CEO this year after concerns over the company's digital strategy, its pace of implementation, and its negative impact on long-term results.

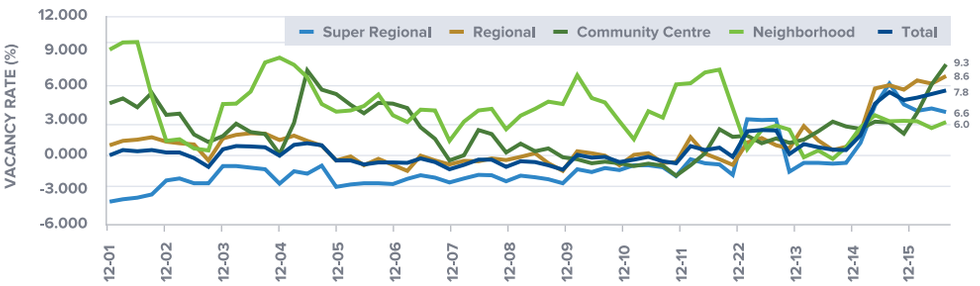
BATTLE FOR A BIGGER SLICE OF A SHRINKING PIE

The ability to implement omni-channelling strategies will differentiate performance among retailers within the Canadian market. These initiatives will not only increase e-commerce sales but also help drive shoppers in-store, increasing overall sales. Fewer winners will emerge at the demise of many more losers. As the overall macroeconomic backdrop is not overly favourable at the moment, there is increased competition for a bigger slice of a shrinking pie. The bottom line: absent a significant positive shift in the macro-economic backdrop (namely higher GDP growth, employment, and disposable personal income), fewer and fewer successful omni-channel strategies will win-out in the battle for consumers' dollars—ultimately shrinking the overall need for bricks and mortar space.

In recent years we've witnessed consolidation in the grocery segment, with Loblaw's taking over Shoppers Drug Mart and Sobeys purchasing Safeway in order to better compete with the likes of Walmart and Costco. This year, a couple of major acquisitions occurred that will continue to reshape the retail landscape as competition intensifies. In the pharmaceutical space, McKesson Corp. acquired Rexall and its 470 retail stores in a $3.0 billion deal. McKesson had previously acquired Katz's (Rexall) independent outlets and franchise business—primarily operating as I.D.A. and Guardian—for about $920 million in 2012. McKesson is now well positioned to compete head-to-head with Shoppers Drug Mart (Loblaw) nationally. In the home improvement sector, Quebec-based retailer Rona was acquired by Lowe's for $3.2 billion in May after it had rejected a hostile bid from them of $1.76 billion 2012. Lowe's plans to convert 40 big box Rona stores to its flag, across Canada in 2017, with another 17 in Quebec scheduled in 2019.

The pathway to purchase continues to evolve to an iterative omni-channel customer journey.

4.9 RETAIL VACANCY



SOURCE: MSCI REALPAC/IPD

AMAZON IS RETAIL'S BIGGEST THREAT

Amazon will increasingly pose the biggest threat to all Canadian retailers. 2016 saw the launch of free same-day delivery in Toronto and Vancouver areas for Amazon Prime members—which is forcing other retailers to step up their online game in a hurry. From Amazon Go to Amazon Echo, the introduction of private labels, and its delivery drones—including its recent patent filing in the U.S. for an "airborne fulfillment centre," or floating warehouse—Amazon is certain to continue as a massive disrupter across the retail landscape in the years ahead. Amazon Go signals its intent to become a major brick and mortar retailer after having opened a number of physical book stores in the U.S. this year. Using artificial intelligence, Amazon's "just walk out" grocery shopping experience has the potential to overhaul grocery—a category that is highly commoditized and perhaps lends itself best to a pure "frictionless ecommerce experience" or "zero-click ordering." The more commoditized, the more transferable the retail category is to a pure ecommerce play. Books, electronics, music, movies, and office supplies are commodities that are virtually interchangeable from one retailer to the next, and sell better online than items that are specific to a particular store or that customers want to see and touch. While this is only one grocery store, it's likely to have a major impact on the pace with which traditional retailers invest in improving their online platforms and in-store experience. As digital business intelligence firm, L2 Inc., points out—human interaction, which Amazon is focused on eliminating for the sake of efficiency and speed—can be a retailer's point of differentiation and method of combatting Amazon. Landlords and retailers will need to collabourate on "placemaking"—transforming shopping centres into destinations for experiences. Recent research from CBRE defines "placemaking" as: "very simply, an effort to draw people to a place by creating compelling reasons for them to visit". In order for placemaking sites to be successful they should:

—Have a clear vision of what the place is trying to achieve
—Understand what works and what doesn't
—Be authentic—deliver what is promised
—Be about people—make them feel different
—Deliver layers to peel back—with each layer something else to experience
—Be curated

CBRE outlines five key elements to consider when curating experience:

—Leisure—restaurants, bars, cinemas, sports facilities, and events to maintain visitors interest longer
—Technology—full digital integration using the latest advanced technologies
—Sustainability and well-being—environmentally responsible development and operations to appeal to a younger demographic who values this philosophy
—Vertical retail—going "up" to support higher density targets of sustainable communities
—Planning—critical to integrate retail, office and residential together

Evidence from this past holiday shopping season in the U.S. is provides support of this trend as an ICSC survey indicated that 70% of all adults in the U.S visited a mall/shopping centre—almost half of those dined at a restaurant and just over a quarter saw a movie. 2017 should provide an indication of just how quickly Amazon intends to move on these initiatives, and what strategies traditional retailers intend to employ to combat the digital behemoth.

DEVELOPERS TAKE A MEASURED APPROACH

Construction levels remain stable in Canada with 11.2 million square feet under construction, representing 3.9% of existing retail supply. The majority of construction (77%) is concentrated in three markets (Vancouver, Toronto, and Calgary), with two-thirds of it focused on regional shopping centres and urban mixed-use development. As many regional malls have undergone significant redevelopment and expansion in recent years, the majority of retail development looking ahead will be of the urban mixed-use variety.

Overall vacancy rates are on the rise, particularly in the regional and community shopping centres. Because of the shopping "experience" and ability to drive traffic and flexibly merchandise the retailers, super-regional vacancy rates have trended lower in recent years, although still well above historical averages. Meanwhile, neighbourhood centres—which generally cater to more service-oriented, defensive tenancies—have achieved below long-term average vacancy rates in recent years. Expect to see further fragmentation within these shopping centre categories and further divergence in vacancy rates between super-regional and regional malls for the reasons previously discussed.

For landlords, assets management has never been so critical. With cap rate compression flattening out on across most retail property types and a slow economic growth backdrop, there is no rising tide to lift all boats. Understanding trade area demographics and evolving consumer preferences are critical to allocating capital across the retail sector and within the shopping centre.

Airport Crossing
Calgary, AB

Property Sectors 04

Industrial

TRENDS

—Industrial availability has been on a steady downward trend since the financial crisis, providing upward pressure on rental rates. While construction deliveries are anticipated to slow relative to the robust activity of the prior four years, absorption could surprise to the upside with mounting secular tailwinds.

DEMAND

—Improving industrial demand stateside and a lower exchange rate should support demand for manufacturing space. Surging e-commerce demand will continue to be a boon for the industrial market with distribution space essentially replacing brick and mortar retail in some cases.

SUPPLY

—The need for modern, efficient distribution oriented space with increased clear heights, ample trailer parking, and proximity to major population centres and key transportation networks has spurred most of the recent industrial construction activity. While construction activity has slowed this past year, it's expected to remain steady moving forward to satiate growing warehousing demand closer to the core.

OUTLOOK

—Developers remain prudent despite healthy fundamentals and robust recent demand. Expect to see restraint continue in most markets with uncertainty around the future of U.S. trade under a Trump administration and hesitation until more traditional retailers begin to unveil their logistics strategies.

SUSTAINABILITY

—Distribution operations are taking advantage of technology through automation and increased use of robots. With growing demand for timely "last-mile" deliveries, firms are looking to locate infrastructure closer to consumers rather than in far-flung exurbs. Longer-term this sector could also be the beneficiary of driverless truck and drone technologies, which would allow for more efficient shipping without the limitations of human drivers.

Bentall Kennedy

Industrial: Tightening fundamentals

The growing needs of suppliers to fulfill online customer orders quickly has given rise to the secular importance and growth of distribution and third-party logistics operators in Canada.

STRONG SECULAR TAILWINDS

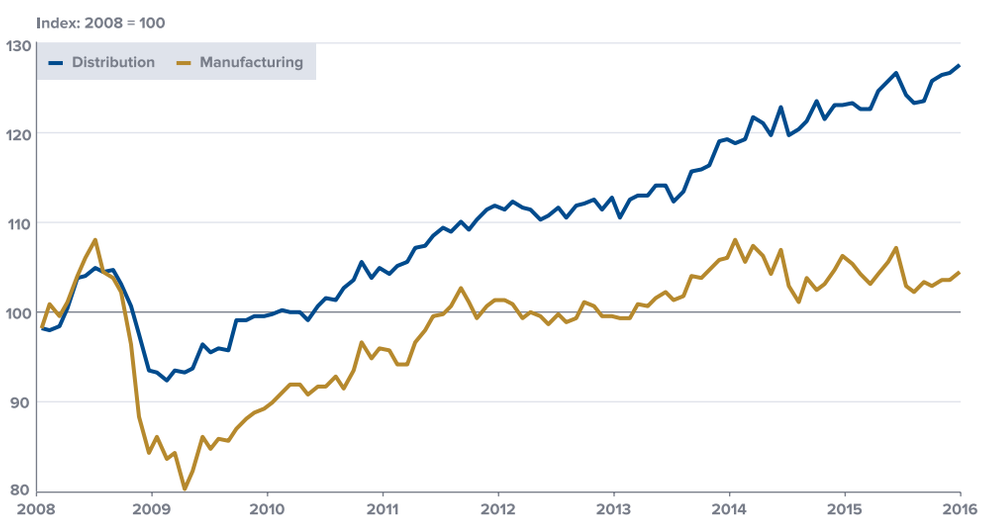
Although cyclical economic conditions have been sluggish across North America, secular changes in the way consumer and producer goods are distributed have become a strong tailwind behind the industrial sector. Indeed, the increasing integration of North American supply chains to improve efficiency—combined with the growth of ecommerce and the growing needs of suppliers to fulfill online customer orders quickly—has given rise to the secular importance and growth of distribution and third-party logistics (3PLs) operators in Canada. These users generally require modern, large bay industrial properties with high clear-heights located close to major population centers and key transportation networks.

BIG BOX INDUSTRIAL REQUIREMENTS

—First wave of 36' + clear height; 40' clear height emerging in US
—52' x 52' or 60' x 52' grid patterns
—ESFR Sprinklers
—T5 lighting at minimum
—Double sided loading; High shipping door ratio; 1 door per 7,000 sq.ft
—7-inch floor slab
—Increased roof load for building/occupier ehancements
—Excess land for secured parking; 1 trailer position per 4,000 sq.ft.
—Shallower building depths 350' – 375'
—Close access to parcel hubs and international airports
—Multiple point of entry for trucks & employee automobiles
—Truck queuing for superior truck maneuvering and staging

SOURCE: CBRE

4.10 MANUFACTURING & DISTRIBUTION ACTIVITY



SOURCE: STATISTICS CANADA

4.11 CANADIAN TRADE ACTIVITY *

SOURCE: STATISTICS CANADA
* DOLLAR VALUE OF IMPORTS AND EXPORTS

LAST MILE WILL DRIVE DEMAND CLOSER TO THE CORE

At the same time, the importance of the "last mile" and the time-sensitive nature of delivering certain consumer goods (prepared food for example) has also increasingly supported demand for "closer-in" industrial properties—many of which tend to be older and feature lower clear-heights. To varying degrees, this trend may reinvigorate some older industrial properties in the inner suburbs that were formerly considered obsolete for modern uses. Consumer demand for more same-day delivery of online purchases will continue to drive retailers to innovate in order to reduce last-mile costs. Along with continuing improvements in m-commerce platforms, this will undoubtedly increase the penetration of ecommerce growth.

While these secular tailwinds are unlikely to suddenly reverse, there are a number of cyclical forces that could impact the industrial sector in Canada going forward. As noted in the economics section, slowing global trade activity combined with increasing protectionist sentiment by a number of key trading partners could disrupt the volume of distribution activity in this country. In addition, the materially lower Canadian dollar is beginning to put pressure on distribution and logistics operators as it generally squeezes the margins of this import-dependent sector.

CAUTIOUS OPTIMISM FOR MANUFACTURING

Offsetting these forces may be the cyclical resurgence of the manufacturing sector in Canada as the economy continues its rotation toward non-commodity exports. Improving industrial demand from Canada's key trading partner, the U.S., combined with a lower exchange rate should act as a powerful source of support for Canada's export-oriented manufacturing sector—particularly those industries in central Canada and BC that have strong ties with the U.S. To be sure, manufacturing has yet to feel the full benefits of the lower exchange rate because of various structural currency hedges put in place during the last decade when the Loonie was trading at a higher level. Moreover, Canadian manufacturing is unlikely to return to its former glory in the 1990s, when it had a much larger footprint in the overall economy and industrial market. This is because a substantial amount of manufacturing activity will simply remain more productive in lower cost jurisdictions like Mexico and China, no matter where the exchange rate trades. Nevertheless, the cyclical improvement of manufacturing demand, even at the margin, should be another source of support for industrial demand—especially among smaller bay properties located in central Canada.

490 Pinebush Road
Cambridge, ON

HEALTHY FUNDAMENTALS OUTSIDE OF ALBERTA

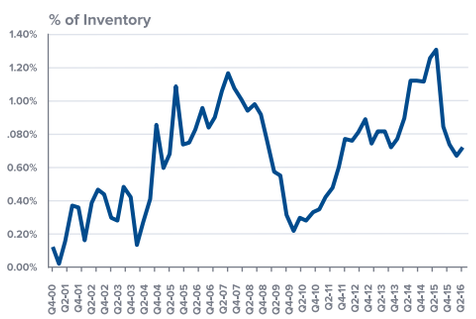
Strong industrial demand has resulted in a continued decline in availability and rising lease rates in 2016, particularly in Toronto and Vancouver:

- Average lease rates in these two regions were up by almost 8% year-over-year as of Q3 2016, while availability rates continued to sit well below long term averages in both cities
- Leasing activity in these two regions has largely been driven by a broad mix of tenant groups including distribution, logistics, and manufacturing
- In sharp contrast, industrial markets in Calgary and Edmonton have experienced a considerable loosening of availability and an easing of rents

Much of this softness, particularly in Edmonton, can be largely attributed to the impact of the energy downturn and weak leasing activity among tenants directly aligned with oil extraction (such as petroleum manufacturers and pipe fitters)—but demand by distribution and logistics operators in Alberta has actually been far more stable. This is especially true in Calgary, which has emerged as the main distribution hub for Western Canada. This comparatively lower orientation toward the energy sector is a major reason why overall availability rates in industrial are much lower than the office market in Calgary.

It is important to note that the secular trend to consolidate logistics operations—especially in Canada's two most important distribution markets, Calgary and Greater Toronto—has resulted in a significant increase in construction during this cycle of larger industrial buildings and industrial parks nearing the 1.0 million sq. ft. mark. While the square footage of new industrial under-development approached record levels at the beginning of last year (albeit on a relative basis), it still only equated to about 1% of total inventory. This is much less than the relative development occurring in the office sector.

4.14 NATIONAL INDUSTRIAL UNDER CONSTRUCTION

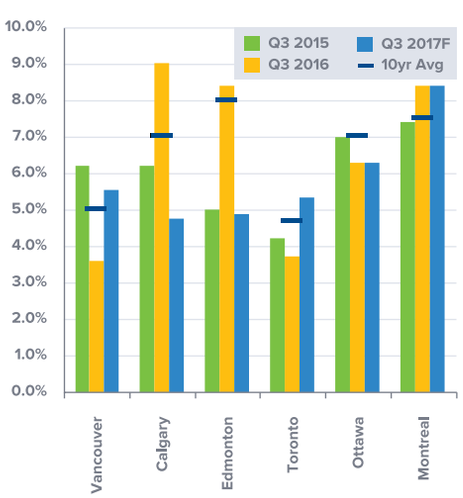


SOURCE: CBRE

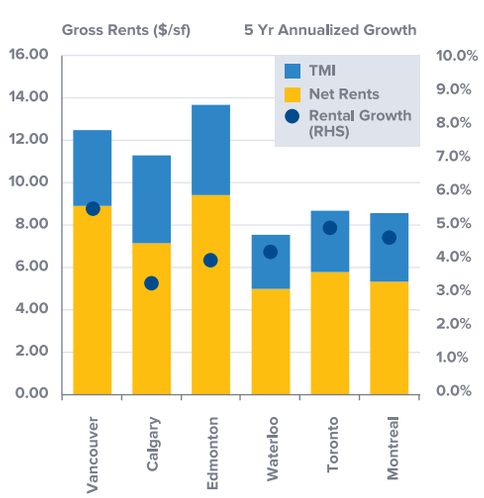
CONSTRUCTION BOOM ENDS IN CALGARY

To be sure, the surge in new distribution space was a major contributing factor behind Calgary's sharp increase in industrial availability last year, since a fair bit of it was speculative. Fortunately, the number of industrial buildings under construction in Calgary has diminished significantly by late 2016, as absorption moved forward while intended new construction has stalled in-line with the recently dour economic mood in the city. New industrial development has also cooled off to some extent in Toronto and Vancouver, but part of this may reflect land shortages and increasing industrial land prices that are creating structural barriers to the pace of new construction. Nevertheless, as long as demand remains strong and industrial rents continue to rise and remain at economically favourable levels, industrial construction (and redevelopment) in these two cities could continue at historically fulsome levels.

4.12 REGIONAL INDUSTRIAL AVAILABILITY TREND



4.13 INDUSTRIAL RENTS



SOURCE: CBRE, BENTALL KENNEDY

Property Sectors 04

2 St. Thomas
Toronto, ON

Multi-residential

TRENDS

—Although vacancy increased slightly over the past year, property fundamentals remain landlord favourable leading to rent growth in most non-energy dependent markets. Alberta continues to see elevated levels of vacancy and deteriorating market rents exacerbated by a glut of new supply.

DEMAND

—Robust immigration, urbanization, and increased housing (un)affordability are strong secular tailwinds for the sector.

SUPPLY

—Purpose-built rental and condo housing starts are down slightly year-over-year but remain well above the long-term average. Conservative underwriting by lenders amidst increasing concern over a housing bubble will help to keep oversupply in check.

OUTLOOK

—Strong secular demand trends should continue to fuel an increased desire for modern purpose-built rental accommodations, preserving landlord favourable conditions throughout most of the country. The ability to deliver new product above development cost and the defensive nature of the asset class will attract further capital into the sector.

SUSTAINABILITY

—Multi-residential development is generally centered on dense, mixed-use neighborhoods, frequently in urban locations. Renters desire proximity to work, access to public transportation, and abundant retail and recreational amenities. In these dense locations, product with desireable features such as fitness centers, outdoor spaces, and pet-care facilities should thrive.

Bentall Kennedy

Multi-residential: Top performing sector

The strength of the long-term outlook for the sector in Canada is predicated on transformative demographics and land use intensification.

There are a number of prominent tailwinds in the multi-residential sector that are both secular and cyclical in nature. Property fundamentals are generally healthy despite some soft spots regionally. The strength of the long-term outlook for the sector in Canada is predicated on transformative demographics and land use intensification.

POLICY AND TRANSIT FUELING DEVELOPMENT OPPORTUNITIES FOR SUSTAINABLE COMMUNITIES

Millennial lifestyle preferences, downsizing baby boomers, and robust immigration are all contributing to Canada's urban population growth. As a result, land use policies are being designed to encourage municipalities to build denser, more walkable communities around key transit nodes. Significant regional transit infrastructure upgrades are underway in many cities across the country. Combined, these elements have become a catalyst for mix-used development which has created demand for higher-density housing, include purpose-built rental accommodations. Community transformation is not only limited to urban metros, but growing suburban markets as well.

Densification policy is intended to slow the rate of urban sprawl, make more efficient use of existing infrastructure, and reduce commute times and congestion. Fortunately, there is also growing demand from all demographics to be part of a "live, work and play" environment—rich with entertainment, shopping, creative offices, engaging public spaces, and housing that meets the needs of a modern urban lifestyle. Increasingly, residential developers are including building amenities such as:

—Outdoor recreation and social spaces
—Bike/car share access
—Dog-care facilities
—State-of-the art fitness centres

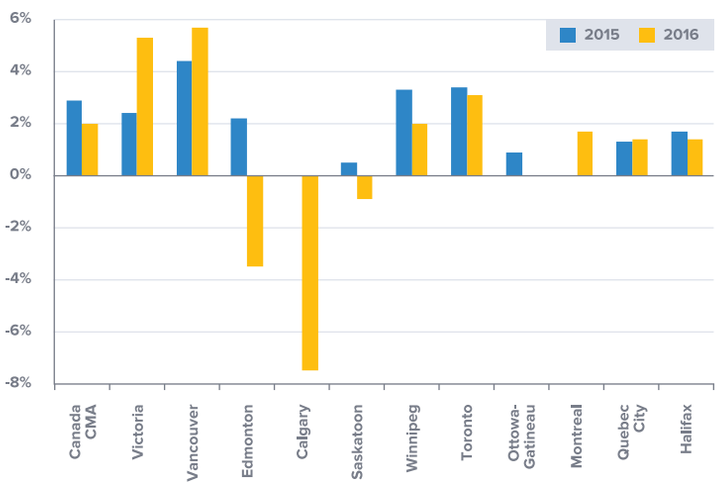
With many new projects outperforming pro-forma lease-up projections, developers are quickly realizing that multi-residential rental properties benefit most greatly from a well-designed, sustainable mixed-use community.

BOOMERS, MILLENNIALS AND IMMIGRATION DRIVE DEMAND

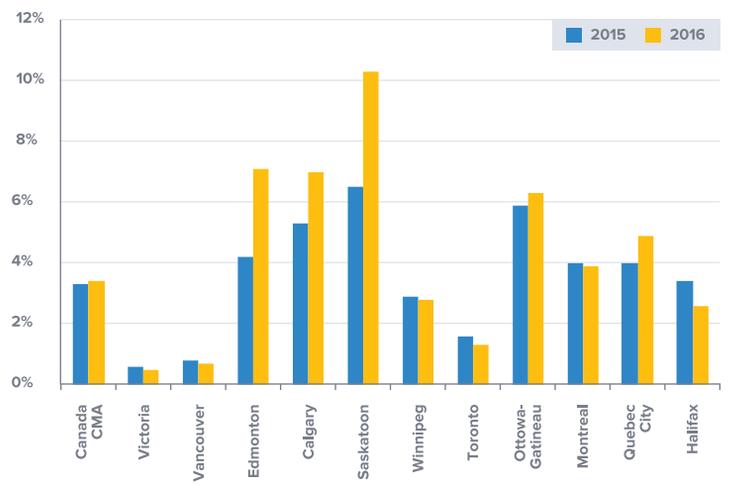
The aging baby boomer population (and increasingly, empty nesters) will continue to drive growth into smaller housing options as they look to downsize from their larger suburban homes. Propensity to live in rental housing typically tends to rise as one enters retirement age. With continuous improvements to medicine and healthier lifestyles, seniors are living longer than ever, providing increased demand for higher-density housing. Like their boomer parents, millennials have found themselves in search of affordable housing options and, more often than not, have chosen to either remain at home or to rent—as home ownership has become increasingly difficult with rapid escalation in prices.

Immigration continues to be a significant driver of housing demand in major Canadian markets. While immigration reform is on the agenda in the U.S., Canada has increased its immigration target for 2017 to 300,000, up (15%) from 260,000. With Canada's inverted population pyramid, immigration will be critical to softening the negative effects of an aging population on the economy.

4.15 RENT CHANGE % FOR A 2-BDRM PURPOSE-BUILT APARTMENT



4.16 OCTOBER VACANCY RATE - APARTMENT STRUCTURES OF THREE OR MORE UNITS



SOURCE: CMHC

TORONTO AND VANCOUVER EMERGENCE ON THE GLOBAL STAGE

Toronto and Vancouver are emerging as truly global cities. While still a safe distance from the likes of New York, London, Hong Kong, and Tokyo in terms of cultural and economic influence on the world stage, they are highly desirable places to live at a relatively good value. Toronto and Vancouver continually rank high in The Economist's "most liveable cities" as they are revered as exceptional cities to "live, work and play."

The economic strength and cultural vibrancy of these cities is well-reflected in their respective multi-residential property fundamentals:

- Vacancy rates in Toronto and Vancouver have all trended lower year-over-year, displaying the lowest rates (each sub-2%) in any major market in the country for the last two years
- This has translated into year-over-year rental increases with the cost of renting a two-bedroom apartment in Vancouver 5.7% higher than in 2015, and 3.1% higher in Toronto over the same period
- Not surprisingly, the turnover rates in these cities are the lowest in the country, with only 16% of units vacating as tenants are less likely to transition to home ownership or find improved value in rental accommodations
- Low turnover is likely understating the potential uplift in market rents as rent controls in each of the respective provinces act to limit the increase in rent on renewal

The energy downturn in Alberta has had an adverse effect on the rental markets in Edmonton and especially Calgary.

—7.5%

AVERAGE RENT DECREASE FOR A TWO-BEDROOM APARTMENT, CMHC OCTOBER 2016 YEAR-OVER-YEAR

ALBERTA FUNDAMENTALS WEAKEN TO HISTORIC LEVELS

In contrast, the energy downturn in Alberta has had an adverse effect on the rental markets in Calgary and Edmonton:

Not unlike the office sector in Calgary, a glut of new condominium (shadow supply) and purpose-built rental units have been delivered to the market in the past couple years. CMHC reported that 1,296 purpose-built rental units were added to the inventory in 2016—representing an increase of 3.7%, the strongest year-over-year gain since 1994:

All told, the average rent for a two-bedroom apartment slipped 7.5% to $1,258. While energy prices have stabilized, there has been very little optimism on the employment side. As a result, one emerging trend that does not bode well for the sector is the out-migration from Alberta to other provinces. A net of 3,850 people left the province in the third quarter, marking the fourth consecutive quarter of increasing out-migration for Alberta.

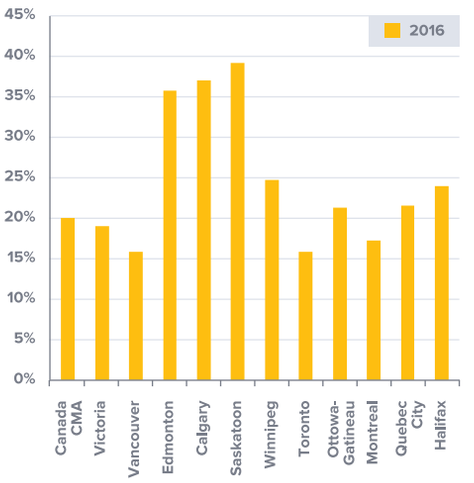
Similarly, Edmonton added 4% to its purpose-built rental universe which outstripped demand, pushing the vacancy rate up 290bps to 7.1%—the highest since the mid-1990s. This weakness led to a 3.5% drop in rental rates, which marked the first year of negative rent growth since the financial crisis.

Although property fundamentals have deteriorated significantly over the past year in Alberta, there still remains a buoyant market for rental accommodation that provides modern amenities—in-suite, on-site and within the neighbourhood. The multi-family rental stock in Edmonton and Calgary is remains heavily skewed towards older generation buildings that do not meet the tastes and preferences of Millennials and young professionals.

4.17 NET INTERPROVINCIAL MIGRATION TO AND FROM ALBERTA

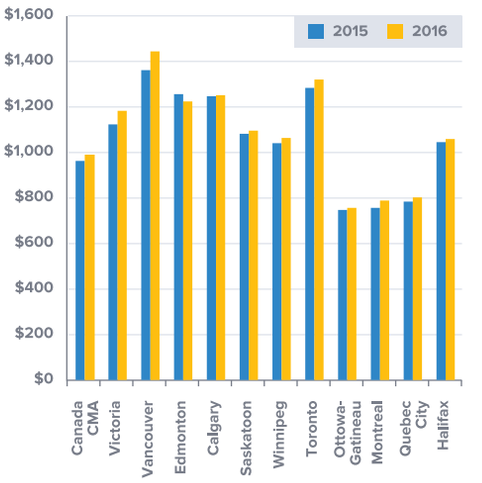
SOURCE: STATISTICS CANADA

4.18 UNIT TURNOVER RATES



SOURCE: CMHC

4.19 AVERAGE RENT 2-BDRM (NEW AND EXISTING STRUCTURES)



SOURCE: CMHC

ERODING AFFORDABILITY AND RISING INTEREST RATES SUPPORT TIGHTER RENTAL MARKET CONDITIONS

Canada remains a nation of homeowners with propensities to own over rent evident across all demographics, even millennials. However, in Canada's major cities, most notably Toronto and Vancouver, rapidly-rising house prices have made home ownership less attainable, particularly for those contemplating home ownership for the first time. Recent measures taken by the federal government to tighten mortgage rules are anticipated to help cool the housing markets across the country—but it has yet to be seen how much impact it will ultimately have on affordability. In fact, RBC Economics suggest that:

- More stringent rules to qualify for a mortgage will represent a higher ownership hurdle for some
- Rule changes are poised to restrict or alter the pricing of certain mortgage options available in the marketplace, similarly creating further challenges to home ownership for some buyers
- Any pullback in affordability could be outweighed by rising mortgage rates—whether organically through rising interest rates or by way of lenders passing through additional regulatory costs

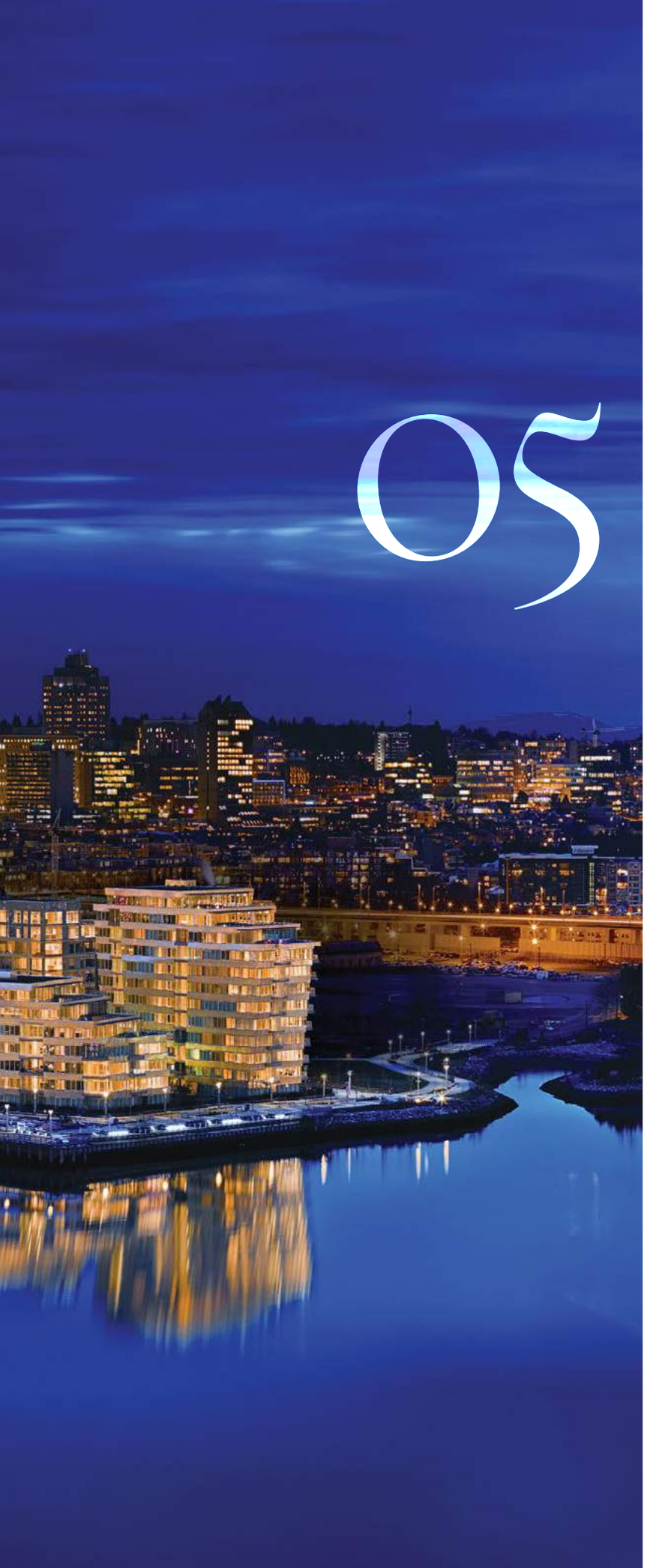
The federal government has been proactive to ensure a soft landing in the housing market by addressing the demand side of the equation. However, in addition to the demand drivers discussed within the Canadian economic outlook, there is much debate as to what is truly constraining housing supply—leading to further price escalation and deteriorating affordability. Whether land use policies, a lack of serviceable land or municipal red tape and lengthy approval processes, a lack of quality housing options to meet growing demand is exerting upward pressure on prices. Combined, these supply and demand factors bode well for landlords in the rental market, which is anticipated to continue to tighten in the year ahead.

STRONG RETURNS WITH FURTHER STABILITY AHEAD

Total returns as measured by MSCI REALPAC/IPD registered 8.5% for the twelve months trailing as of September 2016. This was largely a result of 4.0% capital appreciation driven by lower cap rates and NOI growth. Multi-residential was a top performing sector as the strong secular tailwinds (discussed within) in Toronto and Vancouver were not to be overturned by the cyclical headwinds in Alberta. Given the tailwinds discussed, particularly within the Greater Toronto and Vancouver markets, it would not be surprising to see strong rent growth continue through 2017. Weight of capital into the sector is anticipated to persist with robust demand and good access to inexpensive CMHC-insured debt which should act to absorb any uplift in interest rates to preserve pricing levels. Multi-residential has traditionally been a less volatile asset class. Therefore, as we get further along into the cycle there is apt to be further rotation into the sector to the extent that product is available.

Portfolio
Calgary, AB

Olympic Village
Vancouver, BC



05 Regional Overviews

VANCOUVER

Economy:	Outperform
Industrial:	Rising
Downtown Office:	Rising
Suburban Office:	Rising

TORONTO

Economy:	Outperform
Industrial:	Peaking
Downtown Office:	Peaking
Suburban Office:	Peaking

EDMONTON

Economy:	Average
Industrial:	Declining
Downtown Office:	Declining
Suburban Office:	Declining

OTTAWA

Economy:	Outperform
Industrial:	Rising
Downtown Office:	Bottoming
Suburban Office:	Bottoming

CALGARY

Economy:	Average
Industrial:	Bottoming
Downtown Office:	Bottoming
Suburban Office:	Bottoming

MONTREAL

Economy:	Average
Industrial:	Rising
Downtown Office:	Bottoming
Suburban Office:	Declining

NOTE

—Economic outlook is based on the Conference Board of Canada's 2017 real GPD growth forecast for major metros relative to its national average forecast (2.0%)

—"Declining" and "bottoming" outlooks indicate tenant favourable conditions which tend to exert downward pressure on net effective rents while "rising" and "peaking" outlooks indicate landlord favourable conditions which tend to induce upward pressure on rents

Bentall Kennedy

Vancouver: Outperforming despite housing slowdown

Vancouver had one of the fastest-growing metro economies in 2016, thanks largely to record-level residential and non-residential construction activity. The finance, insurance, and real estate sectors along with technology industries have also been key contributors to growth in the region. Looking ahead, economic momentum is likely to slow somewhat in the city as a number of policy measures aimed at cooling the region's overheated housing market—including a foreign residential buyers tax and stricter mortgage insurance rules—dampens transaction activity. Partially offsetting slower domestic growth, the region's transportation and warehousing sector, along with other export-intensive industries, should see stronger activity as they continue to reap the rewards of a low Canadian dollar and firmer trade volumes. Indeed, Vancouver remains a key port city and a major North American "gateway" to Asia.

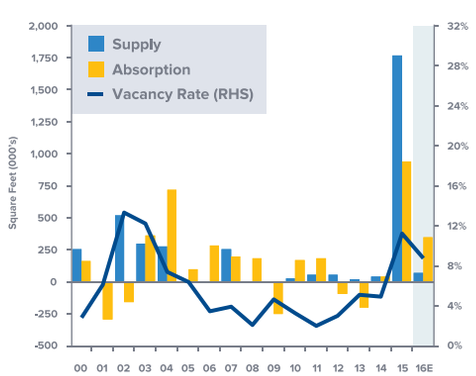
GLOBAL "SAFE-HAVEN" FOR CAPITAL

With significant international visibility and its "safe haven" reputation, Vancouver was a magnet for foreign investment in 2016—with core urban assets commanding especially strong demand from offshore buyers. Strong overall investor demand, together with limited supply of product (as well as developable land), resulted in a compression of cap rates for most property types in 2016. In many instances, pricing has become disconnected from current property fundamentals as underlying land values and future redevelopment potential influences investors to compress yields to record lows on in-place income. Supply and demand imbalance is unlikely to change materially in the upcoming year; expect commercial real estate pricing in Vancouver to remain some of the most expensive in Canada, if not North America.

TECH SECTOR ACTIVE DOWNTOWN

Office leasing activity continues to improve in downtown Vancouver, particularly for top-tier space. Technology tenants in particular have been active in this market, leasing larger blocks of space—especially in new developments. 1.8 million sq. ft. of new space has been delivered in the past two years driving the vacancy rate higher—well above its long-term average of 6.0%. Consequently, net rents—particularly in older buildings—softened over the past year. Landlords of this older space will continue to work aggressively to attract tenants in the coming year, especially as further new supply comes onto the market in 2017.

5.1 CLASS 'A' OFFICE FUNDAMENTALS DOWNTOWN



SOURCE: CBRE, BENTALL KENNEDY

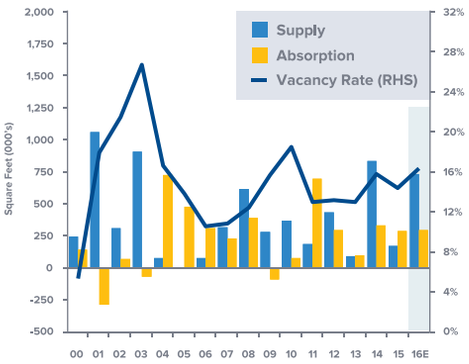
1.8m square feet

NEW SPACE DELIVERED IN DOWNTOWN VANCOUVER, 2015–2016

TRANSIT ORIENTED LOCATIONS OUTPERFORM

Suburban office demand, especially around major transit locations, held relatively firm in Vancouver. Although net effective rents continued to increase in the suburbs, much of this growth was attributed to the recently delivered product. As further new supply arrives in this market—particularly around the Broadway corridor and Surrey—expect suburban office vacancy rates to move higher in the coming year.

5.2 CLASS 'A' OFFICE FUNDAMENTALS SUBURBAN

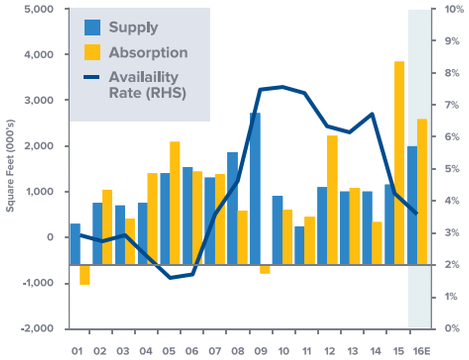


SOURCE: CBRE, BENTALL KENNEDY

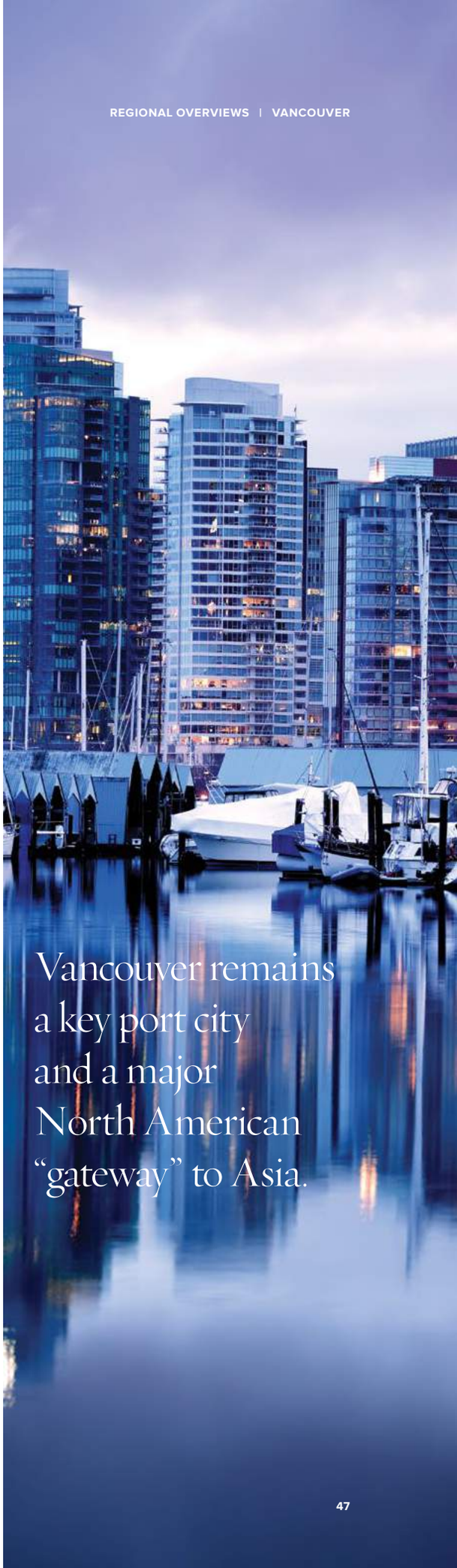
NEW SUPPLY REBALANCES INDUSTRIAL MARKET

Vancouver's industrial market is currently one of the tightest in North America. Demand has been relatively diverse, supported by traditional tenant sectors such as distribution, logistics, and manufacturing, as well as film and television—which has benefited from both a lower Canadian dollar and favourable tax incentives. With demand outstripping supply, Vancouver industrial net rents steadily increased last year and are approaching the highest in the country. However, new supply—particularly in Delta and Surrey—is likely to catch up to demand in 2017; these dynamics should push the overall market back to more balanced conditions over the coming year.

5.3 INDUSTRIAL



SOURCE: CBRE, BENTALL KENNEDY



Edmonton: Highest unemployment in 20 years

While Edmonton has a more diverse economy than Calgary, no sector has gone unscathed as weak energy prices continue to cause pain across the metro area's economy. Unemployment spiked to its highest level in 20 years, and the local economy is expected to contract for a second year in a row. One bright spot has been non-energy construction resulting from the downtown's revitalization with commercial projects helping to stabilize the labour market. Cautious optimism has resurfaced as a pro-oil U.S. President-elect has promised to give the go-ahead to the Keystone XL pipeline once in office. Accordingly, Edmonton's manufacturing sector would benefit greatly from the construction and servicing of this pipeline. Economic growth could return as early as next year with oil prices stabilizing and the public sector continuing to grow.

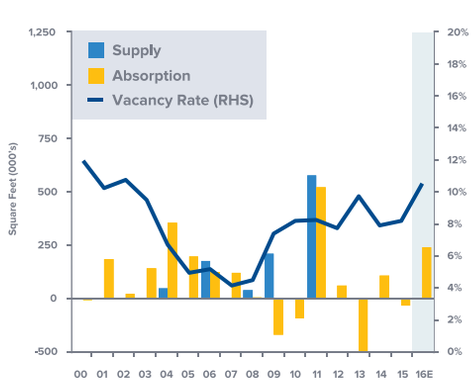
VALUES BELOW LEVELS EXPERIENCED IN THE FINANCIAL CRISIS

Investment transactions in Edmonton are up year-over-year thanks to a number of retail transactions that recorded pricing reminiscent of pre-recession levels. Generally, investors are looking for signs of sustained economic recovery before deploying capital into the Edmonton market. Risk premiums have increased significantly in the office sector—particularly in the suburbs where fundamentals have weakened dramatically. While valuations have held up fairly well in the retail and industrial sectors, the office sector has given back all of the gains since the last downturn. Access to debt capital is becoming more difficult (increasingly relationship based) as many lenders are looking to reduce their exposure to Alberta.

OPTIMISM OVERSHADOWED BY WEAK FUNDAMENTALS

Downtown office leasing fundamental continued to weaken this year—with vacancy rising beyond 13% and anticipated to face upward pressure for the foreseeable future in the absence of any new tenant demand. Two buildings remain under construction, adding over 8% to the inventory in the next 16 months. The revitalization of the downtown will hopefully be a catalyst for new businesses to locate within the urban core. However, those organizations which already have a presence in the downtown are the ones driving demand by consolidating satellite offices from the suburbs. It's becoming increasingly important to look past the averages in Edmonton; landlords who have invested in their buildings should be able to differentiate themselves from the pack in order to attract and retain tenants, preserving occupancy.

5.4 CLASS 'A' OFFICE FUNDAMENTALS DOWNTOWN



SOURCE: CBRE, BENTALL KENNEDY

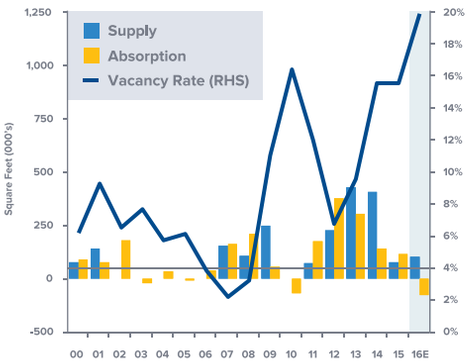
13.3%

2016 VACANCY RATE, DOWNTOWN EDMONTON, Q3 2016 CBRE

SUBURBS WILL REMAIN CHALLENGED

An oversupply of office space and anemic demand are anticipated to put continued downward pressure on suburban occupancies and rents in the near-to-medium term. Professional services tied to the E&P and oilfield service companies have downsized and consolidated, adding sublet space to the market. More optimistically, with the development cycle now in the rear-view mirror, the fundamental rebalancing is underway.

5.5 CLASS 'A' OFFICE FUNDAMENTALS SUBURBAN

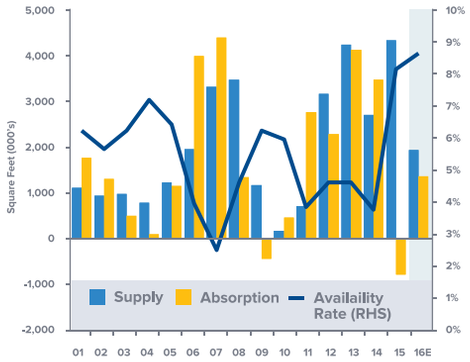


SOURCE: CBRE, BENTALL KENNEDY

NOWHERE TO HIDE

Exposure to oil and gas is pervasive across all submarkets in the industrial sector. As a result, absorption has waned in recent years, pushing availability towards double digits. The submarkets of Nisku and Leduc—which possess the majority of the small bay space that caters largely to petroleum-related manufacturing and other tenants servicing the oil patch—have been particularly hard hit by the downturn. New development is likely to be more restrained going forward, with ability to adjust to economic conditions much easier in comparison to other property sectors with shorter development timeframes. For this reason, industrial fundamentals are expected to rebound gradually; however, further capex cuts in the energy sector are certainly a risk to the rate of absorption.

5.6 INDUSTRIAL



SOURCE: CBRE, BENTALL KENNEDY

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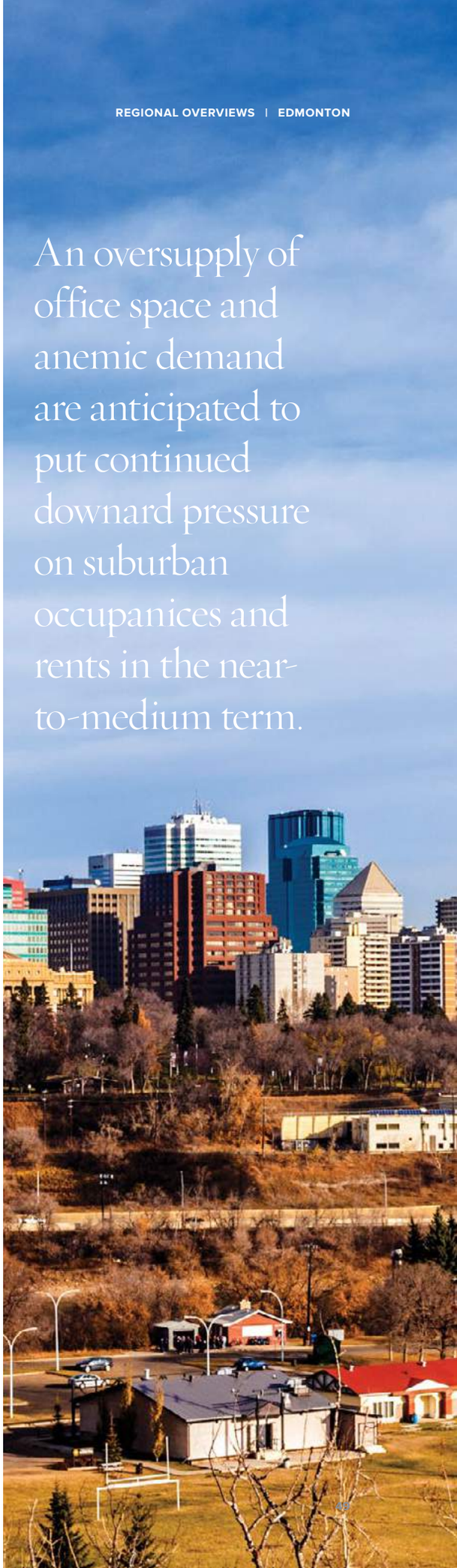


Calgary: Near bottom?

As the head office hub of Canada's energy sector, low oil prices in 2016 continued to hurt Calgary's economy. Not surprisingly, primary and utilities, manufacturing, and business services—all sectors with close ties to the energy industry—experienced significant declines for a second consecutive year. Even those sectors with less direct ties to energy—like construction, transportation and warehousing, and wholesale and retail trade—all suffered to varying degrees. Fortunately, oil prices appear to have recently stabilized, suggesting that the worst may be over for Calgary. As a result, layoffs and cuts to capital budgets in the oil and gas sector are expected to ease in 2017, laying the foundation for a modest improvement in economic activity over the coming year.

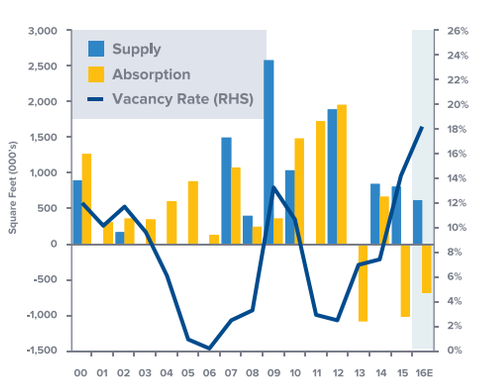
INVESTMENT VOLUME REMAINS SUBDUED

Investment transactions in Calgary increased modestly this year as landlords looking to reduce Alberta exposures finally saw a bid for assets. Reflecting the drop in demand and negative sentiment, perceived risk premiums in property yields increased in Calgary relative to Toronto and Vancouver—particularly in the distressed office sector. However, fire sales were rare as the majority of asset owners remained well capitalized. Industrial sale prices and respective cap rates for high-quality industrial assets held up comparatively well compared to office, partially reflecting Calgary's status as a key distribution and logistics hub for Western Canada.

OFFICE RECOVERY WILL LAG THE ECONOMY

Downtown office leasing conditions in Calgary remained exceptionally poor in 2016, as vacancy surpassed 20%. Extremely weak demand has given way to a significant drop in net effective rents—down approximately 50% from its earlier peak in 2013—with rates at the end of 2016 sitting at their lowest on record. The downturn has been especially apparent in the sublease market as sub-lease landlords present potential tenants with significant concessions. Fortunately, the pace of negative absorption in downtown Calgary appears to be easing, with demand proving most resilient in higher quality space. However, office vacancy is likely to continue moving past 25% this year as a significant amount of new supply is poised to arrive on the market. The continued extreme imbalance between supply and demand suggests that any meaningful turnaround in Calgary office rents remains a distant prospect.

5.7 CLASS 'A' OFFICE FUNDAMENTALS DOWNTOWN



SOURCE: CBRE, BENTALL KENNEDY

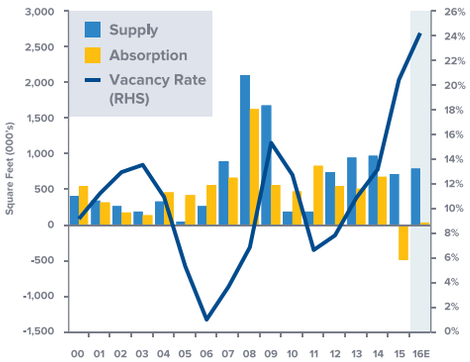
—50%

PERCENTAGE DECREASE IN DOWNTOWN OFFICE NET EFFECTIVE RENTS FROM PEAK IN 2013, Q3 2016 CBRE

SUBURBS HOLDING UP MARGINALLY BETTER

Office vacancy also pushed past 20% in suburban Calgary in 2016, although rents have held up relatively better than their downtown counterpart. This performance partially reflects a more diversified tenant base in suburban Calgary. With the new supply pipeline also winding down, suburban office vacancy in Calgary is likely to peak in 2017 but will have a long way back to frictional vacancy levels where rent growth will be achievable.

5.8 CLASS 'A' OFFICE FUNDAMENTALS SUBURBAN

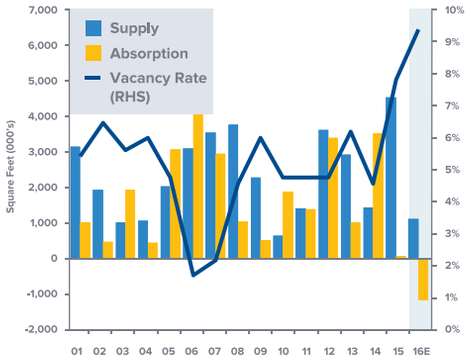


SOURCE: CBRE, BENTALL KENNEDY

INDUSTRIAL MARKET BOTTOMING OUT

As a key distribution hub for Western Canada, Calgary's industrial sector has been more immune to the oil shock than office. Still, overall industrial availability increased to nearly 10% over the past year, with the weakest demand concentrated in smaller bay space—which typically caters to tenants servicing the oil patch. Also contributing to rising availability has been the steady spate of new industrial supply that arrived on the market over the past year. Most of this mainly speculative space consisted of large (over 1 million sq. ft.) distribution buildings which are being slowly absorbed given current market conditions. Fortunately, there are significantly fewer projects left in Calgary's new industrial pipeline, suggesting that overall industrial availability should gradually fall over the next two years while net rents begin to stabilize.

5.9 INDUSTRIAL



SOURCE: CBRE, BENTALL KENNEDY

Layoffs and cuts to capital budgets in the oil and gas sector are expected to ease in 2017, laying the foundation for a modest improvement in economic activity over the coming year.

Toronto: The strongest economy in Canada

Toronto will continue to be one of Canada's fastest-growing metropolitan regions in the near term. The domestic side of the region's economy is expected to remain strong and fuel solid advances in many service-producing industries. Robust trade activity will also add to overall growth, as the low Canadian dollar and improving U.S. demand support activity in key export-oriented sectors, such as manufacturing and tourism. Despite a modest slowdown, low mortgage rates combined with steady population and job growth should continue to drive vigorous housing activity in the GTA and, accordingly, an active construction sector.

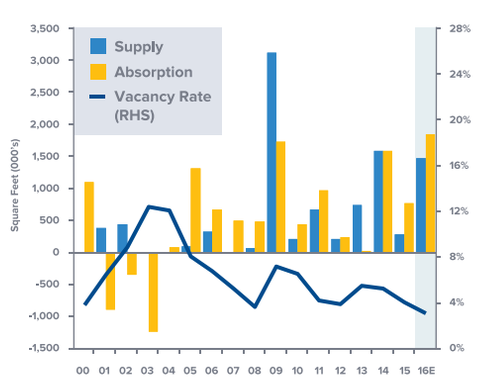
CAP RATES COMPRESS FURTHER ON INCREASED CAPITAL FLOWS

Comparatively healthy economic fundamentals combined with Toronto's strong reputation globally have spurred record demand for real estate in 2016. As capital poured into the region, overall property cap rates in Greater Toronto continued to compress—particularly among best-in-class assets in urban areas. So long as interest rates do not materially increase, investor demand is likely to continue outstripping supply and push property yields in Greater Toronto even lower in the upcoming year.

LOWEST DOWNTOWN OFFICE VACANCY RATE IN NORTH AMERICA

Downtown Toronto boasted the lowest office vacancy rate in North America (4.2%), with the breadth and depth of tenant demand continuing to surprise on the upside. Strong growth in tech and other creative industries has also fuelled robust demand for brick and beam space, with increasing pressure on office rents even outside of the core. Amidst these conditions, downtown Toronto's new office supply pipeline remains active. While much of the space arriving on the market over the next two years is spoken for by existing tenants, landlords of the older vacated space remain cautious and will continue to work aggressively to keep their space competitive.

5.10 CLASS 'A' OFFICE FUNDAMENTALS DOWNTOWN



SOURCE: CBRE, BENTALL KENNEDY

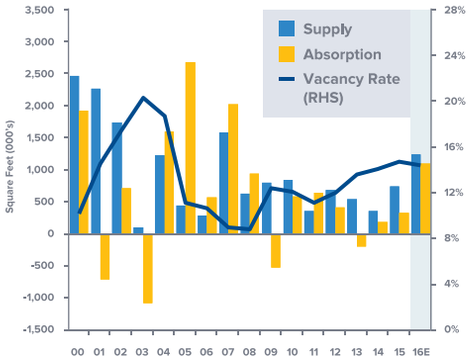
4.2%

DOWNTOWN TORONTO OFFICE VACANCY RATE LOWEST IN NORTH AMERICA FOR MAJOR METROS, Q3 2016 CBRE

SUPPLY REMAINS AMPLE IN THE SUBURBS

Leasing activity in suburban GTA has also been favourable, especially around key transit nodes and major highway interchanges. However, with the new office development in the suburban GTA remaining active, functional/locational obsolescence will continue to be a risk for older properties in these regions.

5.11 CLASS 'A' OFFICE FUNDAMENTALS SUBURBAN

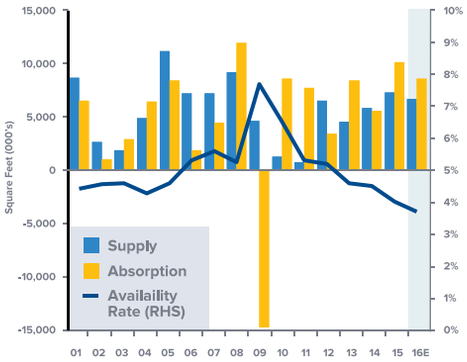


SOURCE: CBRE, BENTALL KENNEDY

INDUSTRIAL FIRING ON ALL CYLINDERS

Like its office counterpart, Greater Toronto's industrial market remains one the tightest in North America. Demand has been especially robust for large bay distribution space, while smaller bay space—particularly closer in—has increasingly grown in favour. Strong demand amidst steady new supply has resulted in record-high industrial lease rates in Toronto, with the west end being the most expensive. As the GTA continues to grow, developable land has become increasingly scarce, putting upward pressure on land values. This factor, along with tight fundamentals and sharply rising market rents, has translated into record industrial sale pricing in Toronto, particularly in the west end.

5.12 INDUSTRIAL



SOURCE: CBRE, BENTALL KENNEDY

Despite a modest slowdown, low mortgage rates combined with steady population and job growth should continue to drive vigorous housing activity in the GTA and, accordingly, an active construction sector.

Ottawa: Happy Birthday, Canada!

Ottawa is anticipated to be a primary beneficiary of increased federal government spending over the near term, helping to boost growth and employment. The non-residential construction sector continues to be the main engine of economic growth, with construction of the LRT and a number of other public projects in the works—including the rehabilitation on Parliament Hill. Although still well below long-term average, housing starts are expected to reverse their downward trend of the past three years as excess inventories clear and discouraged home builders become more optimistic. 2017 also marks Canada's 150th birthday with celebrations anticipated to drive tourism growth in the nation's capital throughout the year.

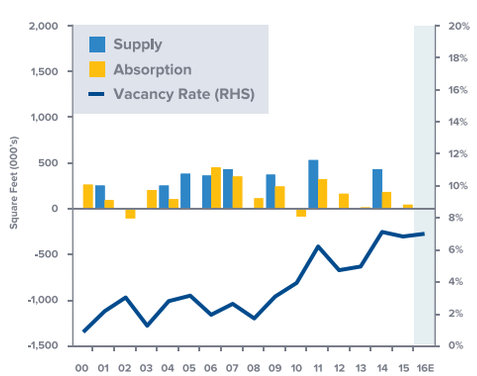
ROBUST INVESTMENT IN MULTI-RESIDENTAIL

Ottawa has experienced an increase in investment activity this year as demand has increased for both multi-residentail properties and development sites along the planned LRT route. Relative value is beginning to emerge as cap rates have not compressed to the same extent they have in Toronto, Vancouver, and—to a lesser extent—Montreal.

TENANT'S MARKET IN THE NEAR TERM

Absorption levels in the downtown Ottawa office market are anticipated to improve (albeit modestly) under a Liberal government as a result of increased demand from expansionary fiscal policy and a likely bigger government relative to the Conservative years. With muted demand across all sectors, vacancy rates have been on a gradual rise since 2007. However, more recently this has been a result of the federal government's consolidation of office space due to their implementation of Workplace 2.0. Consequently, a flight to quality has transpired with increased demand for Class A buildings—which has created a divergence in vacancy rates between best-in-class A buildings and the balance of the inventory. Amongst private sector tenants, demand has largely been induced by favourable incentive packages put forth by landlords to secure tenure.

5.13 CLASS 'A' OFFICE FUNDAMENTALS DOWNTOWN



SOURCE: CBRE, BENTALL KENNEDY

150th

2017 MARKS CANADA'S 150TH BIRTHDAY: CELEBRATIONS ARE EXPECTED TO DRIVE TOURISM GROWTH IN THE CAPITAL CITY

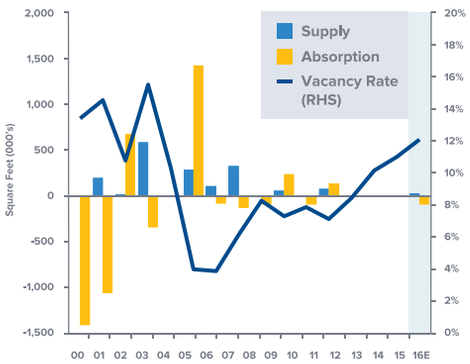
KANATA A BRIGHT SPOT

The suburbs of Ottawa are quite a different story, with the exception of a resurgence in leasing demand within the high-tech submarket of Kanata. Generally, absorption in the suburbs has been feeble as tenants are beginning to seek out downtown locations in order to attract and retain young professionals in search of a "live, work, play" lifestyle. This divergence is anticipated to continue as light-rail transit increases connectivity to downtown from the suburbs. Empty space vacated by the federal government could provide attractively-priced opportunities for tenants looking to relocate.

INDUSTRIAL STEADILY IMPROVING

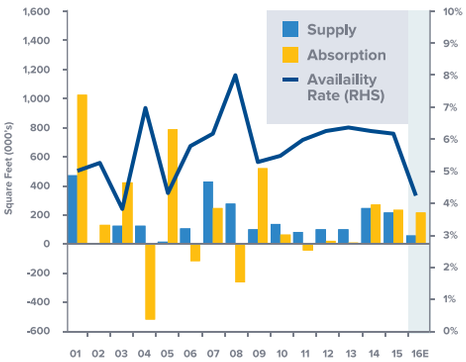
Healthy tenant demand has recently outstripped new supply—exerting upward pressure on industrial rents. Stability in the overall availability rate has masked underlying submarket volatility. Tenant migration out of the East End has caused an increase in availability over the past four years while the reverse has been true for all other submarkets, particularly in the West End which has been the primary beneficiary of this outflow. With limited construction activity in the pipeline, the market has shifted to landlord favourable and is anticipated to remain there over the near to medium term.

5.14 CLASS 'A' OFFICE FUNDAMENTALS SUBURBAN



SOURCE: CBRE, BENTALL KENNEDY

5.15 INDUSTRIAL



SOURCE: CBRE, BENTALL KENNEDY

A flight to quality has transpired with increased demand for Class A office buildings—which has created a divergence in vacancy rates between best-in-class A buildings and the balance of the inventory.

Montreal: Economy poised to improve

Montreal's economy is expected to grow by just 1.6% in 2016 as the construction sector, fueled by large public infrastructure projects, picked up some of the slack in the housing market. In 2017 growth is poised to trend upward to 2.0% which would reflect the highest rate of growth since 2011. Optimism resides in the manufacturing sector, which is anticipated to finally reap the rewards of the sustained low Canadian dollar, a strengthening U.S. economy, and provincial government spending intended to help manufacturing companies adopt the latest in technology and innovation.

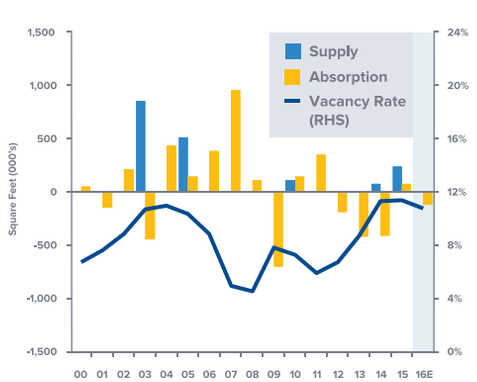
INCREASED ATTENTION FROM DOMESTIC AND INTERNATIONAL PLAYERS

Transaction volumes are expected to finish relatively stable for 2016, with multi-family and office transactions attracting the most interest. As has been the case in Ottawa, cap rates have not compressed to the extent as they have in Toronto and Vancouver. Consequently, Montreal could see an influx of capital in the year ahead from both domestic and international players looking for improving economic momentum and compelling relative value. On that note, recent downtown office transactions have pushed cap rates lower for best-in-class, trophy assets—despite headwinds in the office market due to elevated vacancy rates.

DOWNTOWN FLIGHT-TO-QUALITY

Increased optimism for employment gains on an improved economic outlook is welcome news for a downtown market that has experienced negative absorption in three of the past four years. Vacancy has increased to 11%; however, flight to quality has resulted in a widening spread between the overall and Class A vacancy rate, which sits at 8.1%. Fundamentals are anticipated to remain tenant favourable as increased options across all building classes emerge due to a flight to quality as a result of new product being delivered to market. Landlords of non-trophy assets have been forced to provide attractive inducements in order to compete with a growing interest in loft or "brick and beam" space in the Midtown market, as well as emerging suburban options as public transportation networks improve. Adding further strain to an over-supplied market is the secular headwind of space rationalization, as many organizations are reducing their floor space per employee.

5.16 CLASS 'A' OFFICE FUNDAMENTALS DOWNTOWN



SOURCE: CBRE, BENTALL KENNEDY

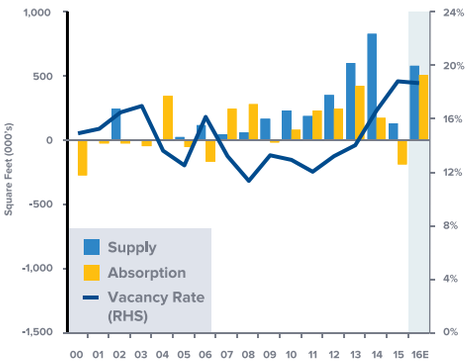
18%

2016 VACANCY RATE IN SUBURBAN MARKET, FOLLOWING THE DELIVERY OF 2.3 MILLION SF OF NEW SPACE OVER THE PRIOR FIVE YEAR PERIOD

SUBURBS TO REMAIN TENANT FAVOURABLE

Robust construction activity in the suburban market is expected to keep fundamentals unbalanced and tenant favourable. The vacancy rate (18.0%) is anticipated to peak in 2016, following delivery of more than 2.3 million square feet of new space over the past five years. With elevated vacancy rates across the overall office market, it will take vastly improved and sustained employment gains to absorb space to a frictional vacancy level where rent growth is once again achievable.

5.17 CLASS 'A' OFFICE FUNDAMENTALS SUBURBAN

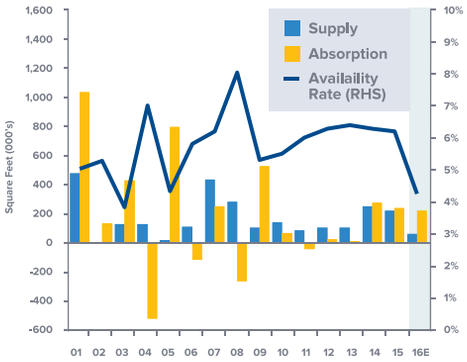


SOURCE: CBRE, BENTALL KENNEDY

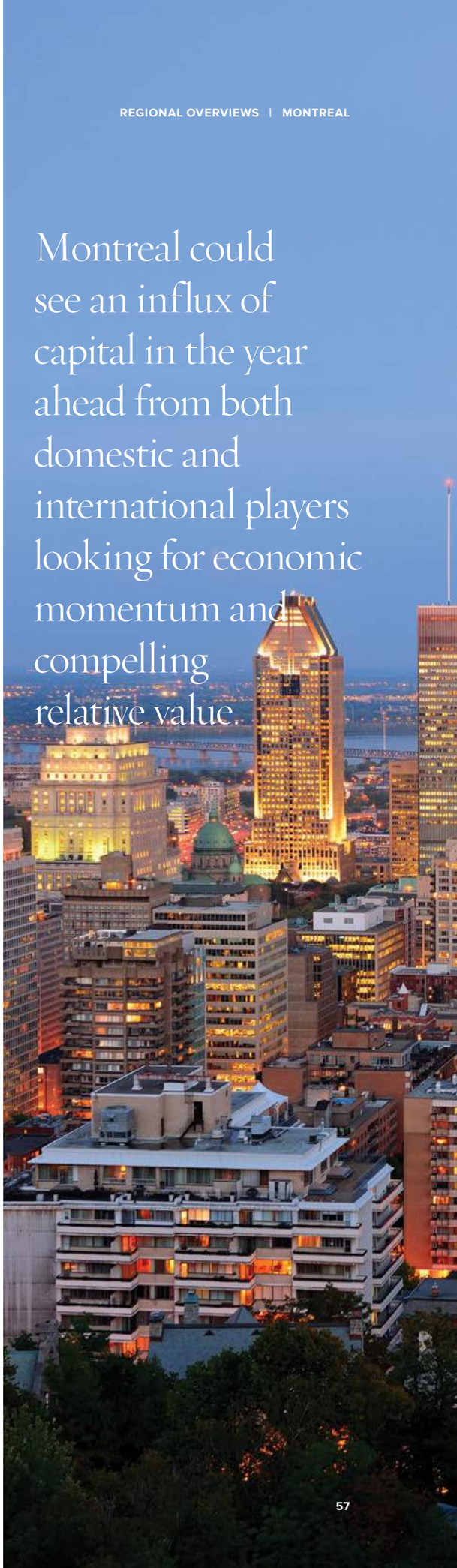
OPTIMISM ON EXPORT GROWTH

Improvements in transportation infrastructure and expectations for growth in exports have resulted in greater leasing activity within the industrial sector in the second half of the year. There is a limited supply of high-quality space located close to transportation networks that possess modern functionality. As a result, tenants have been looking to upgrade space upon lease expiry to better position themselves and take advantage of the anticipated economic growth. With a favourable economic outlook and modest delivery of newly constructed space, availability is anticipated to continue its downward trend—exerting upward pressure on rents which have been relatively stagnant in recent years.

5.18 INDUSTRIAL



SOURCE: CBRE, BENTALL KENNEDY



Montreal could see an influx of capital in the year ahead from both domestic and international players looking for economic momentum and compelling relative value.

Bentall Kennedy Group

Bentall Kennedy, a Sun Life Investment Management company, is one of the 30 largest global real estate investment advisors and one of North America's foremost providers of real estate services. Bentall Kennedy serves the interests of more than 550 institutional clients and investors managing approximately $46 billion of assets across 60 million square feet of office, retail, industrial, and multi-residential properties throughout Canada and the U.S. (as of September 30, 2016). Bentall Kennedy is a member of UN PRI and a recognized Responsible Property Investing leader ranked among the top firms around the globe in the Global Real Estate Sustainability Benchmark (GRESB), for the sixth consecutive year since GRESB was launched.

Bentall Kennedy includes Bentall Kennedy (Canada) Limited Partnership, Bentall Kennedy (U.S.) Limited Partnership and the real estate and commercial mortgage investment groups of certain of their affiliates, all of which comprise a team of real estate professionals spanning multiple legal entities. The assets under management shown here include real estate equity and mortgage investments of the companies within Bentall Kennedy, and exclude assets scheduled to transition out of Bentall Kennedy. All amounts cited are in Canadian dollars.

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