Introduction

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Another Great Year for Real Estate – The Recovery Firmly Marches Onward

Canada's real estate sector marked another year of outperformance in 2012. Record levels of new issuance, total returns exceeding those of the broader S&P / TSX Composite index, a growing list of IPO and M&A activity, against a backdrop of declining volatility. All cylinders seem to be firing together.

Records abounded during 2012, it seems. New equity issuance reached a **record** $6.8 billion representing a **record** 15% of all issuance on the S&P / TSX. Public debt issuance reached a **record** $2.2 billion. The S&P / TSX Capped REIT Index delivered a 17% total return (22% for 2011) vs the S&P / TSX Composite Index return of 7% (-9% for 2011). Again, this was accomplished with diminishing volatility, as the S&P / TSX Capped REIT Index experienced 9% volatility for the year (13% for 2011) vs the S&P / TSX Composite Index volatility of 13% (17% for 2011).

This extends a remarkable four year recovery in Canadian real estate capital markets, following the dark days associated with the global liquidity crises of 2007 and 2008.

The Canadian markets also continue to distinguish themselves from the U.S. markets. While the MSCI U.S. REIT Index recorded a total return of 18% (9% for 2011), it did so with continuing high volatility of 26% (28% for 2011).

The IPO market returned with gusto in 2012, as five IPOs were completed in the year, totalling $594 million of proceeds, plus another three were announced as prospective offerings for 2013. Interestingly, four of the five completed deals are administered via external management arrangements. Furthermore, all three of the announced deals are likely to be externally managed as well. Each offering has its own reasons for benefitting from external management, but the high frequency of these structures is notable.

The composition of equity new issuance was tilted toward common shares and trust units, with a smaller contribution from convertible debentures. The $6.0 billion of straight equity ($4.6 billion for 2011) was paired with $786 million of convertible debentures ($810 million for 2011), a higher ratio than has been the case over the past several years. This can be expected when equity and unsecured debt are well-priced and readily available to issuers.

Issuance of unsecured debentures more than doubled to $2.2 billion ($0.9 for 2011). Six different REITs / REOCs issued for a total of 15 times in the year (four issued for a total of seven times during 2011). This market continues to benefit from improving liquidity, and perhaps has finally matured sufficiently such that it will remain open throughout the years to come. The rated first mortgage bond market also had a robust year, with $2.1 billion raised in four transactions, one of which closed in the beginning of January 2013 ($1.1 billion in three transactions for 2011).

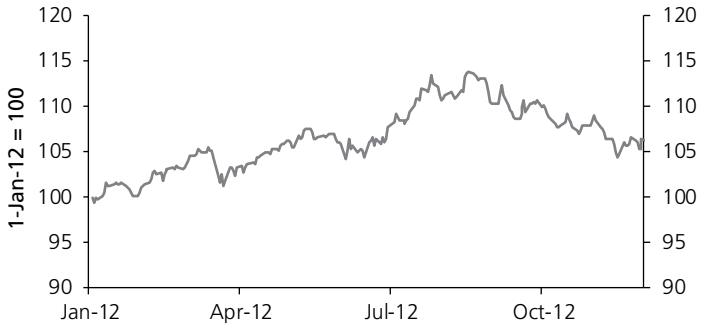
On the M&A front, it was the most active year since 2007. Five transactions were completed, plus one announced, for a combined value of $10.6 billion. Most acquirers offered cash and stock, reflecting a theme of consolidation within the industry.

Transaction volume in the property markets rose as well, up 60% to $16.7 billion in value. Almost half of that volume was office product, involving two rarely traded downtown trophy properties.

With all of these positive developments, there is one over-arching question – is it onward and upward from here? All of the fundamentals seem to be supporting a continuation of this extended recovery. But we will all no doubt be watching intently for any signals to the contrary.

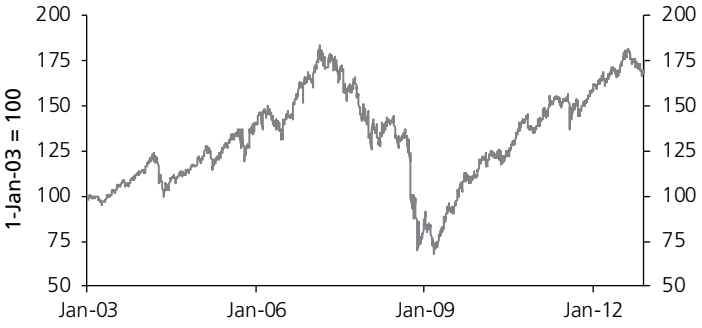
As always, we thank you for your business and we look forward to working with you and your colleagues in the coming years.

S&P / TSX Capped REIT Index One-Year Performance



Source: Bloomberg.

S&P / TSX Capped REIT Index 10-Year Performance



Source: Bloomberg.

Economic Outlook

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The global economy looks to remain mired in sluggish growth through 2013, but there's hope for brighter times thereafter. Europe will struggle to emerge from recession this year, and China won't return to pre-recessionary growth rates just yet. Having outperformed the U.S. through the recession and early recovery, Canada now looks likely to trail America's 2% growth pace by nearly a half point this year. Fiscal tightening in the U.S., and the end to the growth contribution from homebuilding in Canada, will keep a lid on growth in 2013. However, the U.S. will face lighter budgetary headwinds come 2014, and Canada will enjoy a more supportive export environment by then.

If not for the hit from higher taxes and new restraints on federal spending, the U.S. would be poised to accelerate this year. A long-awaited recovery in housing is a key element in that story, creating demand for new construction, increasing activity and prices in the resale market, and spurring related purchases of renovation services, furniture and appliances. That retail activity, and more broadly, a gradual improvement in American consumers' access to credit, also promises to support related retail properties.

But cutting into that growth lift is the drain on spending power from the end of lower payroll taxes, which will cost the typical U.S. household about $1,000 in after tax income, along with other tax hikes more narrowly focused on upper income earners. Spending and tax measures combined will represent a more than 1.5% drag on real GDP growth for 2013.

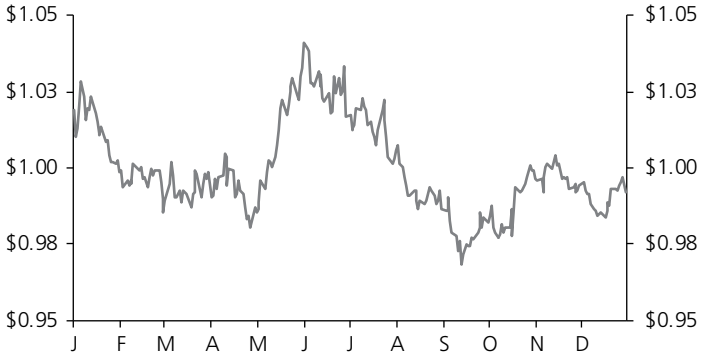
Since no equivalent dose of new tax hikes is envisaged for 2014, we should see the U.S. economy accelerate next year to over 3% growth. While that will still leave the Fed waiting until 2015 to begin hiking the funds rate, talk of the end to quantitative easing toward year end, coupled with the diminished appetite for safe haven government bonds as growth expectations improve, should lift long-term U.S. and Canadian yields through the latter half of 2013, with 10-year rates in both countries topping 2.5%.

Canada's economy was held back by one-off disruptions in energy sector output in 2012, but the growth associated with higher oil output in 2013 will be offset by a downturn in homebuilding. Slower sales activity will weigh on housing starts, particularly in the condominium market, and we also expect to see a modest softening in national average prices. A sharper correction is unlikely in the absence of either a recession or a steeper rise in mortgage rates. Consumer spending has already been brought closer into line with incomes as Canadians' appetite for debt-financed consumption began to wane. Exports and related capital spending have the potential to more than make up for the homebuilding slowdown, but the global growth needed to spur that activity is unlikely to arrive until 2014.

Given those headwinds, the Bank of Canada is likely to retain its 1% overnight target until the second half of 2014, although as noted, further out the curve rates will begin to climb through 2013. For the real estate sector, this will still be a low rate environment, but we will begin to see the waning of earlier benefits achieved by rolling over debt at lower rates.

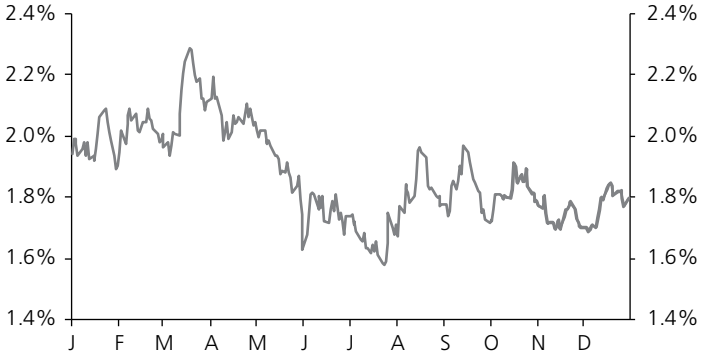
As we saw in the past year, national vacancy rates in both office and industrial space are likely to remain well contained even in a modest real growth environment, and retail properties will continue to benefit from new entrants from the U.S. Although it could average a few cents weaker than parity, a still-overvalued Canadian dollar and weak overseas economies are near-term negatives for the hotel sector, but tourism demand looks to improve with stronger U.S. and global growth to come in 2014.

2012 – U.S. / Canada Exchange Rate



Source: Bloomberg.

2012 – 10-Year Government of Canada Bond Yield



Source: Bloomberg.

Real Estate Equity Market Commentary

Alex Avery
Executive Director,
Equity Research, CIBC World Markets Inc.

A Stockpicker's Market

2012 marked the fourth consecutive year of strong absolute performance by Canadian REITs, with the S&P / TSX Capped REIT Index delivering a +17% total return, and the fourth consecutive year of strong relative outperformance versus the S&P / TSX Composite Index, which delivered a +7% total return. For the first time since 2007, the FTSE / EPRA NAREIT Global REIT Index outperformed Canadian REITs, delivering a 30% total return.

Canadian REITs continued to enjoy a remarkably favourable environment in 2012 that included robust property fundamentals, one of the most stable and balanced economies in the world, declining capitalization rates and an abundance of low cost debt. Over the course of 2012, Canadian REITs saw their valuations rise from levels consistent with long-term averages, to peak levels consistent with the remarkably favourable environment in which they operated.

Among the listed Canadian REITs, the strongest performing sub-sectors were retirement, office, and multi-family issuers. The weakest sub-sector (by a very wide margin) was hotels, while diversified commercial REITs lagged, and retail REITs performed in-line with the overall average. Among the larger-capitalization real estate issuers, the best performers in 2012 were Primaris Retail REIT (+36.4%, driven in part by M&A activity), Allied Properties REIT (+35.8%), Chartwell Retirement Residences (+34.2%) and Boardwalk REIT (+31.7%), while among the smaller-cap issuers the strongest performers were KEYreit (+46.3%), Amica Mature Lifestyles (+22.7%) and Retrocom REIT (+16.7%). The weakest performers were Royal Host (-31.1%) and Extendicare REIT (-0.1%).

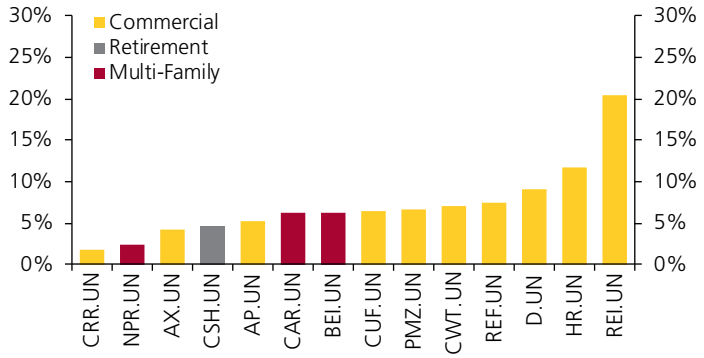
At the end of 2012, the unweighted average yield for our research coverage universe of REITs was 5.7% (5.1% for the S&P / TSX REIT Index), compared to 6.5% a year earlier (5.4% for the S&P / TSX REIT Index). The average REIT yield spread over 10-year Government of Canada bond yields (GoC) of 333 basis points (bps) at December 31, 2012 remains wide by historical standards, but contracted modestly from a very wide 356 bps at the end of 2011. This contraction was driven mainly by REIT yield compression (i.e. rising REIT equity prices), partly offset by a modest decline in the 10-year GoC yield.

The debt financing environment remained quite stable and supportive in 2012, with very attractive mortgage rates broadly available to Canadian REITs and other conservative borrowers. Lending spreads on prime commercial mortgages remained quite stable throughout the year at 180 bps to 220 bps over 5- and 10-year GoCs, with only modest changes in the underlying bond yields driving changes in overall borrowing rates.

Capitalization rates continued to decline in 2012 for the fourth straight year, across all property sectors and markets, with the most significant declines seen in apartment, office and retail properties. Regionally, broad-based and significant declines were seen in Calgary, Edmonton and Ottawa, while Montreal, Toronto and Vancouver saw more modest declines. The combination of record low cap rates and continued wide spreads over the cost of mortgage financing proved effective in driving high transaction volumes, including large portfolio transactions.

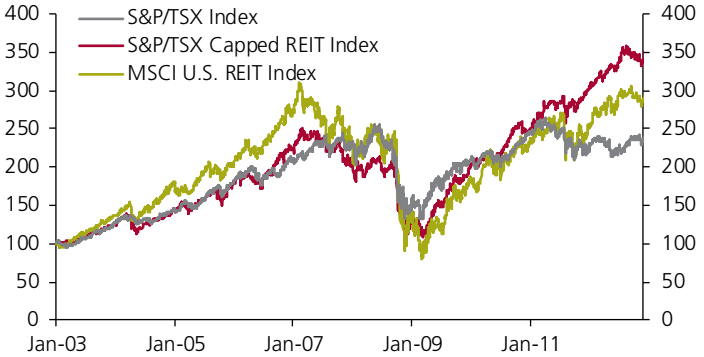
While REITs continued to be significant buyers of property during 2012, other institutional investors were successful in acquiring several large portfolios and notable properties during the year, marking a shift from recent years when the REIT sector dominated acquisitions.

S&P / TSX Capped REIT Index Weighting as at December 31, 2012



Source: Bloomberg.

Historical Performance (Total Return)



Source: Bloomberg.

While current real estate and REIT investment market conditions remain highly attractive in many respects, property and REIT pricing have risen largely to reflect the favourable current environment. We expect attractive returns from Canadian REITs in 2013, but more modest than seen in recent years. In 2013 we expect funds from operations (FFO) growth per unit among Canadian REITs (excluding the more volatile smaller cap REITs and hotels sector) to average approximately 7%, driven by same-property NOI growth, interest cost savings on re-financings and the accretive effects of acquisitions (shopping centre REITs +5%; diversified commercial REITs +6%; office REITs +6%; residential REITs +7%; and retirement / LTC REITs +15%).

At year end 2012, the average Price / FFO multiples for our research coverage universe of REITs and for the S&P / TSX Capped REIT Index were both slightly over 17x, well above historical median levels (~13x and 14x) and close to the highs of early 2007 of over 17x. These pricing levels reflect above average FFO and adjusted funds from operations (AFFO) growth prospects, wider than average yield spreads, strong demand for underlying properties, M&A activity and very low alternative yield investment prospects. On average, REITs in our coverage universe are trading in-line with our estimated net asset values (NAVs).

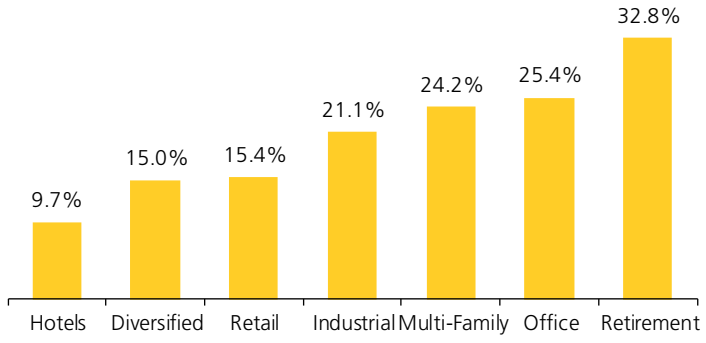
We expect returns from REITs in 2013 to be driven by attractive current distribution yields and modest further appreciation in unit prices. We project annualized total returns over the next 12 – 18 months to average 5% – 10%, comprising close to 6% in average yield and 0% – 5% in capital appreciation. Our capital appreciation expectation reflects a combination of continued FFO growth, partially offset by modest multiple contraction. The hotel REIT sector continues to represent an exception among Canadian property types, lacking the strong property fundamentals seen in almost every other property type, with 2013 prospects for only a moderate improvement.

With valuations reflective of the current environment, we expect outperformance in 2013 by REITs delivering the highest FFO growth. With more than a dozen new REIT formations during 2012, and the potential for as many in 2013, the Canadian REIT universe is expanding rapidly to offer investors numerous new alternatives. We believe these new entrants offer the greatest opportunity for investors to outperform the broader REIT group, with smaller, growth oriented REITs offering significantly higher FFO growth potential than the larger capitalization, more established REITs. However, these new entrants also tend to lack liquidity and a public track record of financial results and / or of management ability to execute strategy.

While we continue to monitor conditions closely, the two factors that consistently spoil attractive property fundamentals in healthy markets, those being cost and availability of debt and supply of new developments, remain muted. Wide spreads and forecasts for higher, but still low benchmark interest rates suggest favourable borrowing conditions could continue. Committed and proposed development activity currently remains measured in the context of the overall inventory of investment property in Canada, notwithstanding development proposals having picked up sharply in recent months.

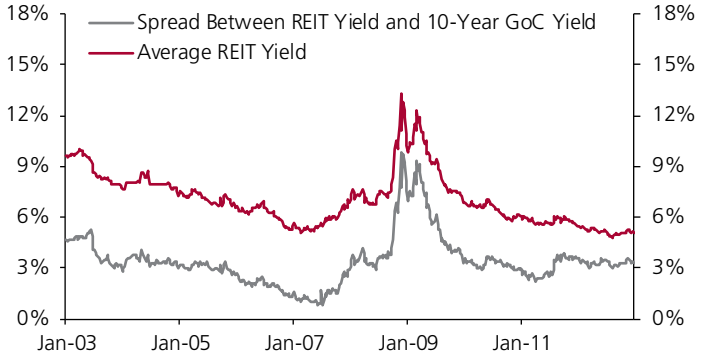
In summary, we expect favourable property and REIT market conditions to continue in 2013, delivering attractive but more modest returns than in recent years. We expect M&A activity could continue in 2013, with privatizations among the higher-quality and larger capitalization REITs, and mergers between smaller capitalization REITs.

2012 S&P / TSX REIT Total Return by Sector



Source: FactSet Fundamentals.
Note: Returns weighted by 31-Dec-12 market capitalizations.

Average S&P / TSX REIT Yield vs 10-Year GoC



Source: CIBC World Markets.