Market value is a widely used but imprecise term for describing the probable price in cash, as of a specified date, for which a buyer and seller acting prudently and knowledgeably, transact real estate. Courts have added to this definition that the buyer and seller must be willing and not under abnormal pressure. The challenge in determining market value in the early days of the COVID-19 crisis is that there are few transactions buyers and sellers can use as a basis of knowledge, many transactions over the next few months may be under abnormal pressure, and there remains great uncertainty as to the length and depth of the virus outbreak.

Our goal in this analysis is to provide a framework for all stakeholders in the real estate industry to use when assessing market value for real estate assets. The market value should be reflective of the prevailing uncertainty and collective perceptions of the market while applying the valuation standards that buyers and sellers must be willing and not under abnormal pressure.

**EY Market survey**

In response to the abrupt changes brought more than by COVID-19, EY’s Transaction Real Estate team interviewed 40 industry professionals across Canada to better understand how recent events are impacting their real estate holdings. Our survey included perspectives from private equity, developers, asset management, REITs and institutional investors, lenders, appraisers, and real estate brokers.

The general consensus was that while early, it is clear that liquidity has been affected and market values across all sectors of real estate are impacted, albeit to varying degrees. Respondents expressed highest concern with retail and hospitality assets. Only 20% of respondents are concerned about the impact to office assets in the short term.

Retail investment was viewed as higher risk prior to March 2020 due to changing trends in consumer spending. Now with further reduction in consumer expenditures, forced store closures and increased reliance on online shopping, many tenants may be pushed into bankruptcy and further reduce the demand for brick-and-mortar real estate. Based on current market sentiment, these structural and long-term impacts on the retail sector point towards an increase in required rates of return.

The hospitality market was perhaps the first asset class to feel the effects of the market disruption when travel bans and major public gatherings were limited or shut down in late February 2020. Hotels, resorts and conference centres will remain in peril until travel patterns resume, resulting in direct revenue loss to owners that will not be recaptured outside of government assistance. Projecting income stabilization within the hospitality industry is difficult as of April 2020, though recovery is expect to be faster than traditional retail assets. Average daily rates (ADRs) are more responsive to demand changes and eventually travel patterns will be easier to project. There is concern for a full hospitality recovery as teleconferencing and other technological options will reduce overall business travel. It is expected that there will be upward pressure on discount rates for hotels and other hospitality assets.
The majority of respondents felt it was too early to adjust yields on office, multi-family and industrial assets. These asset types displayed generally strong fundamentals as of year end 2019 due in part to balanced supply and demand dynamics, prudent development activity and consistent rental growth results over the past three years. The bluntness of a yield rate adjustments seemed to most respondents as too harsh as of Q1 2020. The preferred approach among asset managers was focused on cash flow modifications to Year 1, with expectations that stabilized conditions could be achieved by the beginning of Year 3.

**Valuation perspectives**

Real estate holdings have lower liquidity and less volatility than equity investments. The stock market is an immediate and real time representation of market sentiment; real estate market values tend to move more slowly due to long-term leases, 10-year plus investment horizons and the higher cost and lengthier time to ultimately sell the asset. This is why market values do not adjust as quickly as Canadian REIT prices, which are down 30 to 40% year to date. However this metric does provide a perspective on investor expectations. There is not a “one size fits all” adjustment for COVID-19. Real estate assets are not uniform within asset classes and must be analyzed on a case-by-case basis.

As such, the following commentary is presented, based on market observations as of March 31, 2020, by asset class with regard to COVID-19 valuation implications.

**Office and industrial**

- Existing vacancy lease-up time should be extended. Consideration for lower market rents for units leased in Year 1.
- Market rent growth rates would likely be flat in the first few years, with growth returning in Year 3.
- At the moment, increase in general vacancy and bad debt allowance should be considered, depending on asset class and location.
- Industrial will continue to be a favoured asset class. Warehouse/distribution space demand is likely to remain strong, service- and manufacturing-based industrial will be impacted to a greater extent, with recovery tied to broader economic metrics.

**Retail**

- General vacancy and bad debt allowance should be increased for most retail types.
- Understanding the property’s tenant profile, covenant strength and market exposure is paramount. Renewal probability and market rents will need to be applied in a more customized fashion.
- Grocery-anchored and essential services will perform best, enclosed and regional malls will experience a longer recovery time.
- The viability of some shopping centres will need to be considered and alternative developments may represent the highest and best use; this was however the case for some shopping centres prior to Covid-19, but the crisis will now likely force an accelerated reflection on the future of some assets.
- Assess the probability of recovering any rent deferrals that are granted.
• In return for certain accommodations being made by landlords to tenants during the crisis, landlords will potentially seek to “blend and extend” those retail tenants who they feel will be on a more solid financial footing after the crisis.

**Multi-family**

• To capture the unstabilized nature of the market, a Discounted Cash Flow approach would be warranted to capture near-term challenges or several below-the-line adjustments under the Direct Capitalization Method to capture near-term income loss.

• Market rents and near-term rental inflation will need to be adjusted. Unemployment and overall wealth loss will result in reduced housing affordability for many tenants.

• This may be partially offset by lower operating expenses in the form of reduced utility expenses and property taxes or through government assistance programs.

**Development**

• Construction timelines on existing and new projects are generally being extended by three to six months.

• Labour productivity is expected to be reduced for the foreseeable future. Work safety costs, increased washroom facilities and other social distancing measures are adding costs to active projects.

• Construction costs are forecasted to decline as worldwide demand for materials is expected to be lower for the remainder of 2020. Supply chain issues remain a concern.

• Market feasibility of current and planned projects are being reconsidered. Some projects will be reimagined with new timelines and others while look to reduce density projections.

• Many banks are still granting financing for land under certain conditions.
**Investment commentary**

Respondents expect Q2 2020 real estate transaction volume to decrease significantly relative to pre-March levels. Many of the survey respondents are focused on cash flow preservation within owned assets and have limited capacity to consider capital deployment. Common sense tells us that given the uncertainty, there will be fewer sellers, and buyers will become more selective. The likelihood of a prolonged recession increased in March 2020 (and certainly from YE 2019), which also points towards higher required rates of return. This means that any cash flow analysis will have a much higher risk of not achieving the stated projections. In other words, yield increases are coming.

The mechanics of real estate valuation, however, allow for risk to be priced in various forms. The analysis performed and feedback from the conversations with market professionals indicates that when approaching Q1/Q2 valuations, the most common approach is to adjust short-term leasing and vacancy assumptions for office, industrial, and multi-family assets, while allowing for more market and broader economic data to influence yield rate adjustments in the second half of 2020. There is compelling evidence that the retail and hospitality industries are the hardest hit asset classes, and there is justification to increase discount rates within these sectors on a case-by-case basis. Terminal capitalization rates are generally unchanged for now as the fundamentals of Canadian real estate remain strong and investment capital will return to the marketplace eventually. All eyes will be on transactional data in the coming months to measure if any movements are observed in capitalization rates.

| Immediate short-term impact* |  |
|------------------------------|--|--|--|
| Greatest exposure            | Retail | Hospitality |
| 66%                          | 34%    |
| Least exposure               | Industrial | Multi-family | Office |
| 67%                          | 14%    | 19%          |

*Based on respondents’ portfolio holdings

Will capitalization rates be adjusted/impacted in the short term?

- **35%** No
- **15%** Yes
- **50%** Too early to tell
### EY Market outlook by asset class

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Risk: Short-term</th>
<th>Risk: Long-term</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Retail</strong></td>
<td>High</td>
<td>Moderately high</td>
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<tr>
<td></td>
<td>Retail was immediately impacted, as some companies pro-actively shut down their stores, and others were forced into closure by states of emergency implemented across numerous jurisdictions in Canada. Landlords have seen requests for rent abatements or deferral, which will affect cash flow projections for themselves and their tenants. Smaller retail plazas anchored by grocery stores, pharmacies, liquor stores, and others that have been deemed essential services should fare better than larger enclosed malls with a focus on fashion and non-essential services. Some landlords have pre-emptively set aside capital for mass rent deferral programs in the hopes of securing their tenants’ occupancy throughout this disruption.</td>
<td>Retail is viewed as having considerable risk given the costs and uncertainties around lease-up of vacant space as a result of an extended shutdown. Rent deferrals may not be recovered for some time, or possibly at all. Prolonged shutdowns raise concerns over viability of previously poor-performing retail assets and repositioning to other alternative uses may be needed.</td>
</tr>
<tr>
<td><strong>Hospitality</strong></td>
<td>High</td>
<td>Moderate</td>
</tr>
<tr>
<td></td>
<td>Hotels, resorts, and other accommodations were the first to feel the effects as corporate and leisure travel was restricted or otherwise not recommended. Many hotels have either closed down or are running on reduced staff and services to preserve capital until normal conditions return.</td>
<td>Hospitality is expected to recover more quickly than traditional retail as occupancy and ADR are much quicker to react to changing market conditions than long-term lease commitments seen in retail, though it will not be a rapid recovery. Urban hotel operations are expected to improve once corporate travel resumes, but there may be a reduction as more businesses embrace teleconferencing. Recreational and leisure hospitality assets may see a longer downturn if a recession does take hold.</td>
</tr>
<tr>
<td><strong>Multi-family</strong></td>
<td>Moderately high</td>
<td>Low</td>
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<td></td>
<td>Multi-family may feel short-term impacts as layoffs affect tenants’ ability to pay monthly rent. Government assistance programs will help alleviate immediate concerns, but an extended shutdown will likely affect multi-family portfolios.</td>
<td>Long-term, multi-family is viewed as the lowest-risk asset class. Rental markets perform better during periods of economic downturn. Cities like Calgary have already seen a large shift from home ownership to multi-family properties that have compressed capitalization rates and kept rental rates relatively strong. However, as this asset class is closely linked to population patterns, a reduction in immigration will have an adverse impact.</td>
</tr>
<tr>
<td><strong>Office</strong></td>
<td>Moderate</td>
<td>Moderately low</td>
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<td></td>
<td>Disruption to the office market appears minimal so far. Office tenancies are secured long term with typically stronger covenants, and office space users have not experienced the same disruption to cash flows with the ability for most of the employees to work from home. Properties with higher exposure to co-working tenants may feel more immediate impacts, as individual users of co-working space terminate their month-to-month agreements. Suburban and Class B office buildings will have higher exposure to rent relief requests and near-term cash flow disruption.</td>
<td>It is too early to fully assess the long-term implications for office space, but it is viewed as slightly more risky than industrial and multi-family given the ability to work remotely. Most companies are implementing work-from-home policies at an unprecedented scale. Organizations that had already begun to explore ways to shrink their footprint may find a need for even fewer employees to have permanent desks.</td>
</tr>
<tr>
<td><strong>Industrial</strong></td>
<td>Moderately low</td>
<td>Low</td>
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<td></td>
<td>Warehouse and fulfillment facilities have been a sought-after asset class in recent years and continue to perform well throughout the current crisis due to increased demand for e-commerce. Manufacturing facilities may see a slowdown as a result of the shutdown and general decrease in demand for non-essential production. It may also be negatively impacted by delays in the importing of raw material and labour force falling ill.</td>
<td>Warehouse and fulfillment facilities may see an increase in demand in the long term if an extended shutdown shifts consumer buying habits. Manufacturing facilities are expected to return to normal and will unlikely see a drastic change post recovery.</td>
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### Survey methodology

Over **40 respondents** across Canada

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<table>
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<td>Valuations</td>
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