



CANADIAN
ASSOCIATION OF
ALTERNATIVE
STRATEGIES
& ASSETS

THE CASE FOR REAL ESTATE INVESTING

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asset classes
remains a
powerful way to
diversify market
risk and add true
returns to virtually
any investor's
portfolio

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About CAASA

Inclusive, Active, and Pan-Alternative

The Canadian Association of Alternative Strategies & Assets (CAASA) was created in response to industry requests for a national group to represent the Canadian alternative investment participants, including investors, asset managers, and service providers. CAASA is **inclusive** in that it welcomes participation from all companies active in the space as well as select individuals (such as those employed by investors) who might want to participate in committees and working groups — or simply attend member events — without their employer being a member of the association.

CAASA is very **active** with 12 committees and working groups, organizing approximately 50 events each year. **Pan-alternative**, for CAASA, encompasses all alternative strategies and assets including hedge funds/alternative trading strategies, private and public real estate (funds and direct), private lending, private equity, infrastructure, development and project finance, digital assets/crypto-assets, weather derivatives and cat bonds, and all aspects of diligence, trading, structuring, dealing, and monitoring alternatives in a stand-alone portfolio and as part of a larger investment strategy.

For more information, please visit www.caasa.ca.

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Foreword

Since settlements have been established, real estate is the oldest investment and certainly the most tangible. Being (literally) home for so many and deriving its value from its location, location, location, many investors have an emotional attachment to certain properties and see some as set in its use, ignoring the unlocking of value that can come with re-zoning, renovating, and simple enhancements in its use.

Adapting to constantly changing geographic, category, and demographic markets, as well as fluctuations in financing rates, construction and materials costs, and investor flows is an art that real estate managers in both public securities and direct investments require to do well for investors.

We would like to thank the CAASA Real Estate Group, and each of our sponsors for their important contributions to this work - as well as Rob Ireland and Jacqueline Emery of Claritas Communications for their interviewing and writing skills!

James Burron, CAIA
President, CAASA



Why Real Estate is Appropriate for Many Investors

At first glance, real estate may appear to be the most uncomplicated and approachable category of investment. The various categories of real estate investment are familiar – virtually everyone lives in a bricks and mortar residence, many have worked in office buildings or factories, most have stayed at hotels or resorts and an even greater number have either driven on, or departed from, a significant infrastructure facility. Unlike many other investment categories such as mining and natural resources, foreign exchange, digital assets and biotech, real estate touches the lives of everyone on a daily basis.

Not only are people familiar with real estate, they often own some. It is often said that for most people, their home will be the single largest investment they will ever make. They are very familiar with the ongoing financial stresses that are so often associated with the costs associated with home ownership (down payments, mortgages, repairs, renovations, insurance and utility costs). In addition to a primary residence, many moderate to high net worth individuals own cottages or businesses in which real estate is a significant asset. As such, many investors may feel that they have an over exposure to real estate and that further investment is not needed in their portfolios. However, that perception often skews interactions with investment advisors and prudent allocations within investment portfolios.

More recently, real estate is a topic that seems ever-present given that the affordability of homes has become acutely political in nature. Real estate seems ever present in the news stream: Can people afford to live in large urban hubs? Should governments go further to “cool” hot housing markets? Should central

banks curtail their stimulus policies and raise interest rates – making the prospect of financing a home more expensive? Can the owners of apartment buildings ethically raise the rents of tenants? What is being done to provide community housing? Rather than looking at these market pressures and how they affect lifestyle choices, investors should ask themselves about the opportunities that exist explicitly because of these pressures on home ownership.

Despite the familiarity, home ownership and a miasma of news rhetoric, most people and institutions don’t fully understand the opportunities available in real estate. Accordingly, they have portfolios that are significantly underweight in real estate investment vehicles. Slate Securities has conducted market research to compare institutional and retail investment patterns.



“Institutional allocation to real estate as an asset class has been steadily growing for the last decade and often ranges between ten and thirty percent of a portfolio. Yet amongst most individual investors, there is a massive under allocation to real estate. On average, real estate constitutes four percent or less of their portfolios.”

Jimmy Khing Shan
Partner
Slate Securities

As with all investment portfolios, diversification is key. The good news is that a rebalancing is underway – one led by institutional investors and one being closely followed by individuals who are progressively increasing their holdings in real estate investment vehicles. The future is indeed looking brighter for those choosing to invest in alternative real estate options.

Real Estate Investing and Liquidity

As advisors and their clients consider a rebalancing towards real estate, the illiquid nature of the underlying assets can be a point of concern. To address this, some firms have created structures that provide both liquidity and access to alternative real estate asset classes.



Cecil Baldry-White of Alitis Asset Management explains their approach to liquidity, “We use a multi-strategy, multi-management and multiple investment approach to harness illiquid real estate asset classes (that are largely the domain of institutions) and bring them to the retail market in a more liquid, less concentrated and cost-effective manner. “To provide liquidity, we use cash generated from our residential or commercial income properties as well as cash from refinancing and property sales. Liquidity is also enhanced by our ability to hold a small allocation to publicly traded real estate securities. Real estate is an inherently illiquid asset so we work closely with advisors and clients to understand their liquidity requirements and plan accordingly. We aim to provide up to 1% of fund assets monthly at a discount to net asset value, and 15% of the fund’s assets – at NAV – given six months’ notice. By providing a liquidity wrapper we aim to balance investors’ liquidity requirements with their long-term investment objectives.”

Despite this capability, Cecil admits that “Ideally, publicly traded and private real estate should be positioned as core, foundational elements within a portfolio and are the last elements that should be redeemed.”

Jimmy Khing Shan of Slate Securities noted that, “We allocate a certain percentage of our fund to public investments and a percentage of our fund to private opportunities. We also limit liquidity and redemptions are on a strict, timed basis.”

Other firms stress the alignment of capital to investment structures.



“We work with institutional quality investors - pension funds, endowment funds, large asset managers, and a very large U.S. reinsurance investor - all of whom understand the nature of our strategy regarding real estate investment. As such, we have created private closed-ended funds. The money is locked typically for 7 years.”

David Christie
Partner, Head of Real Estate
ESO Capital

Michael Missaghie of Arch Corporation stresses the need for investors to align their investments with their liquidity requirements. “An appropriate mix of liquid, market-traded real estate instruments and illiquid, private investments (funds or direct real estate) in a portfolio can allow for a range of investment options along the liquidity spectrum. Although public-market securities display higher volatility in the short term – since they are traded daily versus valuation by appraisal in the private realm – they can offer greater liquidity than more discrete private-market, or direct, investments might offer.”

For any significant investment, due diligence is required for investor confidence.

Max Kimpton of Castle Hall reflected, “there has been an erosion of investor trust post Madoff and post the 2008 financial crisis. To shore up confidence, we have introduced the notion of due diligence 3.0 – an evolving requirement for hedge funds and alternatives that want to attract larger investors. Due diligence 3.0 is a process that goes far beyond a one-time report or a single interview. We focus on engaging managers on an ongoing basis to capture data and provide our clients with analytics throughout the year. Essentially, we allow our clients to build their own analytics based off our data sets and manage their risk internally.”

Financial advisors who have taken the time to learn about alternative real estate investments play an essential role – matching investors with the best investment strategy. Irrespective of the underlying strategy, it is clear that to achieve a truly balanced portfolio, most retail investors need to increase allocations to real estate.



Types of Real Estate Investment Categories

Though there is a broad spectrum of opportunity for investment in real estate, it can be useful to understand the characteristics of different real estate property types or categories of lending. The most commonly used categories to delineate types of real estate are residential, commercial, industrial and retail – the lending attributes of which are further differentiated by geography. However, further subcategories have been identified due to their investment profile and market strength.

Residential Real Estate

Houses, townhouses, condominiums, apartment buildings, and vacation homes are included in this category. Given the vastly different dynamics of real estate deemed to be residential, many investors drill down further and specifically break out “multi-family” properties. Reflecting demographic trends, recent reports specifically call out single family residential, condominium and purpose built rentals as separate, stand-alone categories.

Single-family residential

In Canada, the much reported housing shortage and “affordability crisis” for single family residential real estate (especially in Vancouver and Toronto) has had a knock-on effect – driving increased demand for both condominiums and purpose built rental properties. Shifts in demographics and buying patterns can have a dramatic impact on single family residential real estate trends, such as the newly identified trend of older Canadians choosing to stay in their homes and defer traditional downgrading – further tightening the market for new home buyers.

Unique to investment in single family residential real estate is that it is a lifestyle choice rather than an investment for cashflow, appreciation and portfolio diversification. As such, it is particularly influenced by the “news of the day”, speculation, government policies, interest rates and taxation.

Residential real estate also has extraordinarily large variations in valuation by region – largely driven by local employment trends, immigration which tends to be drawn to larger centres, and local government policies as was seen in attempts to first cool the Vancouver market and then in Toronto.

Multi-family residential

Driven by trends in the single family market, multi-family residential is an affordable alternative for many people and can be a highly desirable category for investment, particularly purpose built rentals. Smaller opportunities are often overlooked by larger investors and provide unique market opportunities. However, smaller developers often require additional skill sets and capital to optimize the opportunities.

David Christie of ESO Real Estate explains, “We target smaller companies than many of our peers. We do this as we find smaller projects have stronger returns. The way that we are able to achieve this is by providing “more than money” capital solutions to skilled small property companies so they can grow their businesses. When I say it is more than money...we will be very active in the growth of certain elements of their delivery chain, be it construction, marketing, their banking relationships.”

Senior lifestyle housing

The aging populations of many developed countries is driving the need for specialized, purpose built senior lifestyle housing. Niche segments exist within this category – largely defined by age groups. Some are little more than standard residential housing developments with age restrictions while some specialize in serving people with higher needs (such as onsite nursing and medical care, extensive use of assistive devices and tracking / notification technologies). As populations continue to age, the political power of seniors grows – likely attracting more government programs, oversight and funding with time.

Commercial Property

Interchangeably known as office property, this category includes purpose built real estate for a single tenant through to “sky-scrappers” that have many tenants. Though smaller commercial offices are within reach for many investors, the large office buildings in the downtown core of urban centres are beyond the reach of the majority of investors and as such, tend to be very illiquid.

Long lease terms in office buildings provide stable cash-flow and can protect the owner against market declines but can also limit the ability of property owners to raise rates when necessary to reflect current market conditions. Most property owners have learned the lessons from the financial crisis of 2007-2008 and no longer have tenants who are concentrated in any one sector.

Progressively, co-working office spaces (shared office spaces that provide the services and amenities of a larger company to smaller firms, freelancers and temporary workers) are becoming an important tenant within many office towers in Canada.

Industrial Property

Industrial properties must accommodate the various needs of business and are therefore, extraordinarily varied. This category has the highest percentage of buildings that are either built to the specific needs of the original tenant or they are highly modified (R&D facilities, manufacturing, refrigerated warehousing, etc.). As such, they can be very difficult to lease to subsequent tenants without further modification. Furthermore, industrial sites, especially older ones, may also require environmental remediation.

As a sector, there is strong demand for industrial property throughout North America, driven in part by cannabis production facilities. Additionally, e-commerce is driving significant demand for warehousing and fulfillment centers.

Though this sector can prove to be lucrative for investment, the size and complexity of many industrial properties can only be accessed through large investment.

Retail property

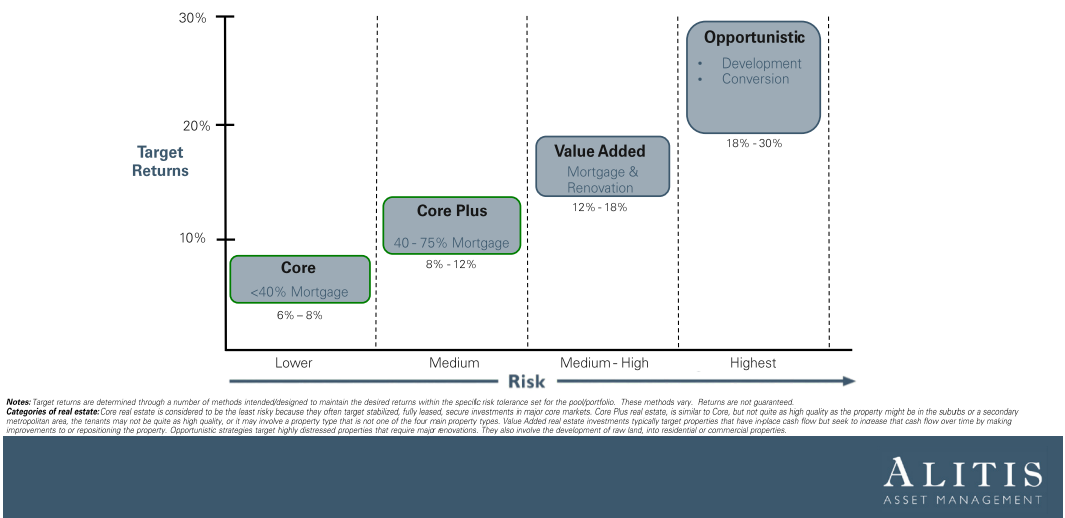
Once one of the favourite sectors for investors, the retail property market is under significant stress and must progressively adapt to the disruptive changes caused by e-commerce. Despite this trend, opportunities for investment still exist – particularly for mixed use malls and complexes with strong anchor tenants such as grocery stores.

As this sector undergoes dramatic change, investors must ensure that there is exceptional due diligence within the operation and valuation of all funds focused upon this property segment.

Real Estate Investment - In Practice

As with most investment options, increased risk within the underlying real estate investment will provide investors with an opportunity for greater reward. In fact, real estate investments have an accepted risk / reward profile that mirror each category. The insights, expertise and experience of fund managers work to both mitigate risk and provide true value to investors.

Private Real Estate – Target Returns



Some firms like Arch Corporation and Slate Securities have the ability to examine the real estate market from both the private and public capital markets perspectives.

Jimmy Khing Shan, Slate Securities noted that, “There is often a disconnect between the public and private markets. The people who invest directly in the real estate market versus those that invest in real estate stock may have different mandates, horizons and scope. This means that the same assets can trade differently in these two markets thereby allowing us to find the best value for money.”

For Arch Corporation, the distinct but complimentary experience of the two principal executives, CEO Daniel Argiros and President and CIO Michael Missaghie, provide investors with the best opportunities whether they exist in the private or public markets.



“When thinking of an investment opportunity we first start by assessing whether we would invest our own capital and then find like-minded investors who want to participate along with Arch in those opportunities. We want to be viewed as an organization that has seed capital invested by the principals alongside capital from investors – achieving a partnership where the fund managers are well aligned with investors.”

Michael Missaghie
President & Chief Investment Officer
Arch Corporation

In North America, Arch Corporation has identified senior lifestyle housing as a sector in which demographics are driving significant growth and potential returns on investment. Michael Missaghie shared, “Arch’s private capital fund is focused on the long-term care market where we see a significant opportunity based on demographics, cash-flow, and an ability to contribute to society in an asset class that is in very high demand.”

Other firms have identified significant niche opportunities with the potential for above average returns and anticipated longevity.



“Over the last fifteen years, the majority of investment capital has gone into the speculative boom in ‘market real estate’ meaning condominiums, medium to higher-end homes and townhomes. Largely, capital has ignored purpose built apartment buildings. This translates into investor opportunity. As such, our specialty is in the multi-family space, particularly purpose built apartment buildings.”

Cecil Baldry-White

Founding Partner, CEO, & Portfolio Manager
Alitis Asset Management

In Europe, ESO Real Estate invests in a very similar niche. David Christie stated that “We do not specialize in any one sector. However, we are currently focused on build to rent strategies in the UK and in areas of Western Europe. This is very much an alternative strategy here in the UK, where as it is a well-established market in the US and Canada. It is supported with very strong demographic and market fundamentals. Enough houses are simply not being built, so there is a massive mismatch in the UK and Ireland between the numbers of houses coming on to the market and actual demand.”

The public and private real estate market is well served by a number of truly innovative and insightful firms. It is clear that investors need to know progressively more about alternative private real estate options. For performance and true diversification, investors should consider mirroring the actions of institutions that have increased their allocations to real estate significantly over the last ten years. To achieve their financial goals, it is particularly important for investors to seek out advisors who, a) make meaningful allocations to alternative investments like private real estate and, b) who run discretionary platforms to manage their clients’ assets.

The Importance of Due Diligence

For Max Kimpton of Castle Hall, due diligence is the key to successfully navigating the various options in real estate investing.



“Regardless of strategy, risk or underlying investments, due diligence is a critical process that must happen both prior to investing and while invested. In many ways, due diligence limits the discussions of liquidity and strategy to a more logical framework – one that truly aligns capital and opportunity.”

Max Kimpton

Director
Castle Hall Diligence

Operational due diligence (“ODD”) enables investors to identify managers who have effective business procedures and operational controls. While real estate funds may not include traded stocks and bonds, investors still consider a range of diligence issues when allocating to the real estate sector.

Liquidity - Are illiquid assets managed within an open-ended or closed-ended fund structure? How is any potential for liquidity mismatch managed?

Service providers - Has the fund engaged an independent third party administrator and a recognized auditor?

Asset existence controls - What external controls are in place to evidence existence of underlying assets?

Cash controls - Does the Manager control cash movements throughout the investment structure? Have dual signature controls been implemented across the fund’s accounts?

Valuation controls - Does the Manager apply a consistent valuation approach? Has a third party valuation agent been engaged to independently value portfolio assets on a regular basis?

Institutional investors also pay close attention to the inherent conflicts of interest which can arise in some real estate structures, notably when asset managers are vertically integrated and provide construction, development, and/or property management services. Castle Hall has noticed that well managed firms are transparent as to sources of income and have clear policies in place around conflicts of interest.

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