Real estate private equity in the Canadian market

DENTONS

April 4, 2024

Real estate private equity (**REPE**) generally refers to the creation of an investment vehicle where funds are raised to acquire real estate assets and generate returns through their management, improvement, development and/or eventual sale.

As the name suggests, REPEs are typically not publicly traded and instead rely on capital from high-net-worth individuals (**HNWIs**), institutions or corporate entities. In many cases, the investment vehicle is structured such that investors are Limited Partners (**LPs**), are managed by General Partners (**GPs**), and the relationship is governed by a Limited Partnership Agreement (**LPA**). GPs collect management fees to cover salaries and costs, as well as performance fees that allow them to share in the profits. The LPA outlines the duration of the investment vehicle, which can be either open-ended or closed-ended.

Open-ended investment vehicles offer more liquidity and operate comparably to mutual funds by allowing LPs the flexibility to redeem their investments on a more frequent and regular basis, with some limitations. Due to the inherently illiquid nature of real estate, managers of open-ended investment vehicles will often lock in capital for a period after the launch of the investment vehicle. To satisfy redemptions, investment vehicle may carry a percentage of liquid assets, impose specific notice and redemption periods, or temporarily borrow funds. Assets acquired by these investment vehicles will typically be bought, improved, and held to generate a steady stream of funds from operations.

Closed-ended investment vehicles sacrifice liquidity for the potential for higher returns than open-ended investment vehicles. When a closed-end investment vehicle is created, GPs generally have a specific period within which they are permitted to deploy capital to acquire assets. The investment vehicle exists for a fixed amount of time, and investment capital is locked in until the close of the investment vehicle. With a view to selling the assets at the end of the term for potentially high returns, such assets acquired by these investment vehicles often require more time and capital to be substantially renovated, developed or redeveloped from the ground-up.

Investment strategies

As in any limited partnership, LPs are only liable to the extent of their capital contributions. In the REPE context, this means that they are limited in their ability to influence asset acquisition or management. Each investment vehicle will therefore have its own mandate set out in the LPA permitting GPs to diversify the investment vehicle's portfolio dependent on the investment objective, strategy and the LP's appetite for risk.

Unique to real estate, factors that influence the risk profile and return potential of an asset are:

- **Type of property**: Multifamily/residential, retail, office, industrial, hospitality and healthcare.
- **Geographic location**: Province or territory, and proximity to economic hubs and transit, population and growth and

zoning.

- **Level of control over the property:** Lease and commercial agreements, title issues and governance.

Other investment strategies include **Real Estate Debt**, where instead of using capital to directly invest in properties, GPs may purchase or provide debt facilities or mezzanine loans to real estate owners; **Funds of Funds**, where GPs invest into other REPEs rather than investing directly in property; and more recently, investing in property technology firms (**proptech**),[1] and **secondaries**, where interests in property portfolios and/or single assets are purchased from existing investors.

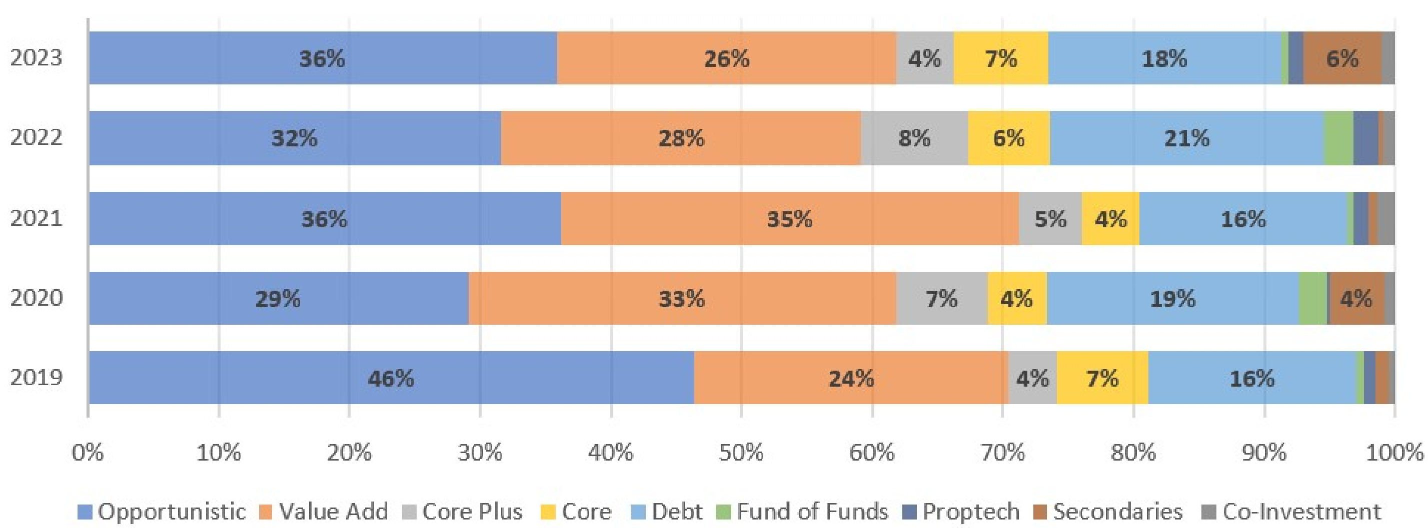
Global market trends

Data compiled by Private Equity International's **PERE** on 3,000 GPs and 4,200 LPs from over 10,700 investment vehicles provides insight into global REPE fundraising trends over the last five years:

- 2020 declined by 12% year-over-year to US$188 billion, largely due to the pandemic.
- 2021 had a 26% increase year-over-year to US$236 billion, returning to pre-pandemic figures.
- 2022 declined by 5% year-over-year to US$225 billion.
- 2023 declined by 38% year-over-year to US$138 billion, primarily due to interest rate hikes, inflationary pressures and geopolitical uncertainty.

Demonstrated by the graph below, GPs have shifted investment strategies. Opportunistic, core, and secondary investments saw higher percentages of overall capital raised in 2023, growing 4%, 1% and 6% respectively. Debt fundraising has seen a decline from a peak in 2022, comprising 26% of total capital raised compared to 35% two years prior.

Global REPE funding strategies by proportion for 2019 through 2023[2]



Canadian trends

Canadian real estate markets followed similar trends, but with a stronger post-pandemic resurgence and a slower decline in 2023.

Commercial real estate investment volumes were at CA$56.6 billion in 2023, down 12.7% from the previous year. While transaction volumes remained historically strong, average deal size was far smaller in 2023. The CA$5-25 million segment of the market was very active, whereas transactions above CA$100 million were at their lowest point in over a decade. [3] Some analysts expect a recovery in the commercial real estate investment market in the latter half of 2024.[4]

Regulatory scheme

National Instrument 31-103 sets out the registration requirements and ongoing obligations for registrants, including investment fund managers, advisors and dealers. GPs selling interests in REPE investment vehicles will need to consider the registration requirements under the applicable categories of registration based on their business. Such investment vehicles are typically sold to investors based on prospectus exemptions available under National Instrument 45-106.

REPE investment vehicles invest in some similar assets as Real Estate Investment Trusts (**REITs**), but they are structurally and operationally distinct. REITs are specifically defined in the *Canada Income Tax Act* (**ITA**)[5] and are generally organized as publicly traded corporations. Investors purchase shares (called units), and profits are paid out as dividends. REITs may provide investors with more liquidity. However they also attract a higher level of securities regulation (including foreign ownership caps) and requirements under the *ITA* in order to maintain their status. These requirements may limit a REIT fund manager's ability to invest in the same variety of asset classes available to REPE investors and in turn, the potential for higher returns.

Dentons can assist with all aspects of real estate private equity matters, including formation, structuring, transactions, closing and tax. For more information, please contact Michael C. DeCosimo, **Colton Riley** or a member of the Dentons' **Real Estate** group.

We wish to thank Emmanuel Egho, an articling student in Toronto, for his assistance with this article.

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[1] Learn more about proptech from our **Spotlight Series** with Proptech Collective.
[2] PERE, '**Fundraising hit an 11-year low in 2023**'
[3] Jones Lang LaSalle (JLL), '**Canada Real Estate Outlook, 2024**'
[4] CBRE, '**2024 Canada Real Estate Market Outlook**'
[5] ***Income Tax Act***, R.S.C., 1985, c. 1 (5th Supp.), s.122.1.

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