August 25, 2021

Canadian commercial real estate Q2 review and outlook

Our Canadian commercial real estate outlook reveals the latest developments across office, industrial, retail, and multifamily property markets.

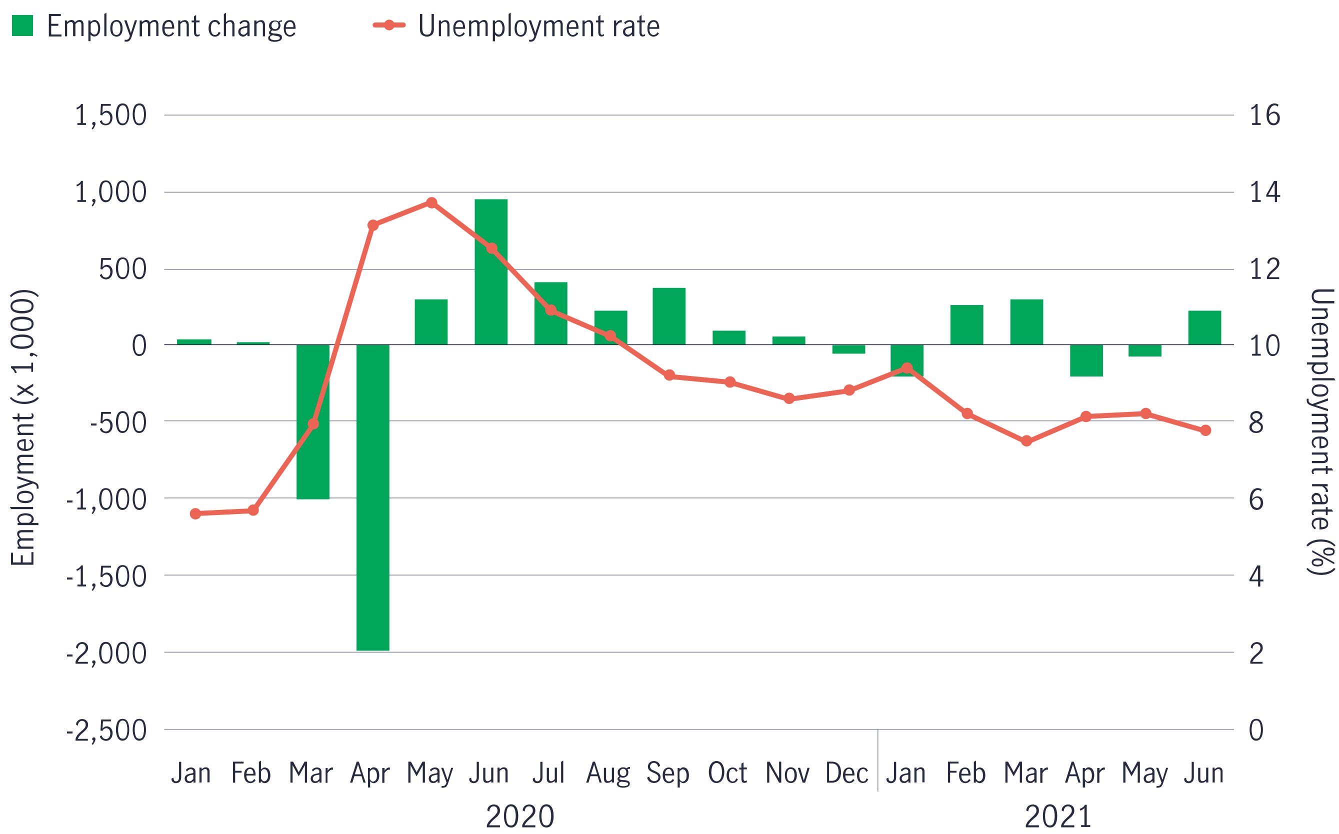
Canadian economic outlook—is the fog of the pandemic starting to lift?

At the onset of the year, uncertainty surrounding a potential looming third wave of coronavirus infections brought out pessimism and added fuel to the fire surrounding a possible double-dip recession. Thankfully, Canada's economic outlook has evolved significantly in the past three months. The second quarter finished with an unemployment rate of 7.8%, after national employment fell by 275,000 jobs in April and May, but regained 231,000 in June,[1] speaking to the momentum after many parts of the country were forced into lockdown during the early spring. After a robust first quarter of GDP growth, reaching 5.6%,[2] Q2 growth is expected to be in near 3.5% despite a resurgence of the virus in March and April.[3]

Riding the tailwinds of stronger-than-expected global economic growth, oil prices have been on the rise over the quarter. Western Canadian Select ended Q1 at US$48.86 and finished the second quarter at US$59.52, a gain of 21.8%. On the other hand, seemingly astronomical lumber prices have somewhat made their way back to earth, fluctuating drastically over the quarter but finishing down 26.9% by the end of June. While lumber prices were up 70.9% year over year at the end of Q2, most forecasts predict prices to moderate in the second half of the year and into 2022 but will likely stay above prepandemic levels. Lower lumber prices are good news for residential developers, who have experienced rising input costs that have dampened new supply at a time when Canada is dealing with skyrocketing housing prices. On a macro scale, housing affordability issues pose a risk to the broader economic outlook in the form of financial instability and restrained corporate competitiveness, encouraging cost-push inflation and potentially reducing migratory flows.

The Bank of Canada (BoC), widely considered among the most hawkish central banks globally, is starting to show signs of unwinding some of the quantitative easing measures that were enacted to stimulate the economy. In April, the BoC announced it would taper bond purchases from CAD$4 billion per week to CAD$3 billion, with a further reduction to CAD$2 billion coming in July. At this point, the BoC has reiterated its commitment to holding the policy interest rate low until it can sustainably achieve a 2% inflation target. Given that these are still the early days of the recovery, we don't expect the BoC to feel comfortable raising interest rates in the near future, with the more likely scenario of a rate hike being put off until 2022, and possibly as far off as 2023.

Canadian employment



Source: Statistics Canada, as of June 2021.

Q2 review and Q3 outlook

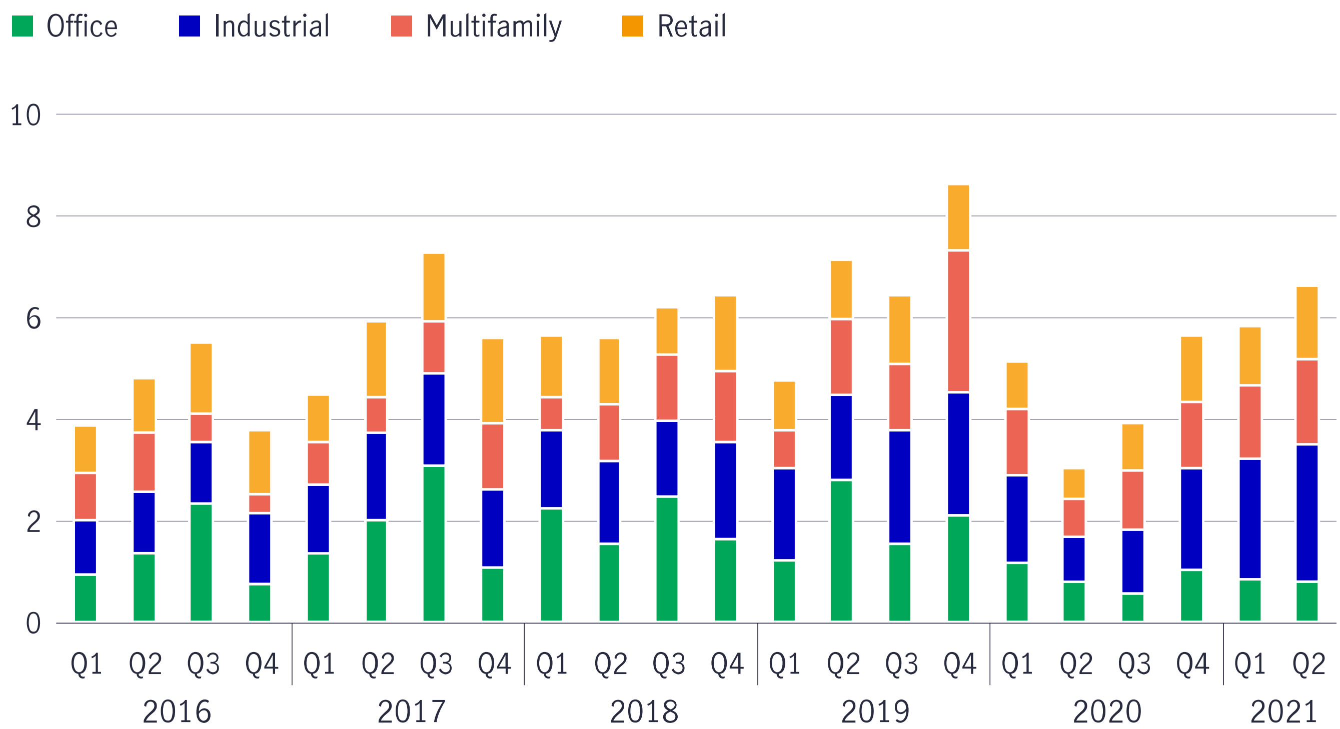
Investment market

Throughout the pandemic, the performance of investment markets has been divergent across the major property types. Industrial and multifamily real estate has shown resilience and has more or less proven to be pandemic proof, the major drivers being a shift to a more online economy for industrial and growing unaffordability of residential homes for multifamily. This was exemplified in the second quarter, as preliminary data shows that Vancouver, Toronto, and the Greater Golden Horseshoe hit record-high transaction volume for industrial real estate. Multifamily also displayed strength as the market sale price per square foot (SF) set new highs in most major markets, with Vancouver leading the pack at CAD$343.45 per SF. Office markets have experienced substantially reduced volumes of sales at value, which have remained stable. CoStar's preliminary numbers for Toronto's office market could potentially drop below

CAD$200 million for only the second time since 2013 but with the silver lining of market sale price per SF remaining stable.[4]

Looking to property returns versus property fund returns, it's interesting to see the impact that leverage has had on the total and net total return indexes. After rising for an astonishing 40 straight quarters from Q1 2010 to Q4 2019, the total return index on direct property investment dipped as a result of the COVID-19 crisis but, over Q1 2021, has shown signs of improvement. Total return fell about 3.8% from its peak in Q4 2019 to Q4 2020, but in the first quarter of 2021, it jumped up 1.1%,[5] a promising sign that the recovery is filtering through to property markets. Property fund performance has fared a little better, as the low interest-rate environment has ensured that the punch bowl stays full. The net total return index for fund investment peaked in Q1 2020, which speaks to the strength of real estate heading into the crisis, and dropped by 3.2% in Q2 2020. Since the second quarter of 2020, when there was the most uncertainty regarding future returns, the property fund index recovered 3.8% and surpassed the previous peak, setting a new record high in Q1 2021.[5] This stark difference in the pace of recovery showcases that investors may potentially benefit from the advantages that property funds offer when compared with direct property investments.

Canadian commercial real estate sales volume transactions



Source: CoStar, as of Q2 2021. National data represents aggregate data for markets tracked by CoStar, which include Calgary, Edmonton, Ottawa, Toronto, and Vancouver.

Office market

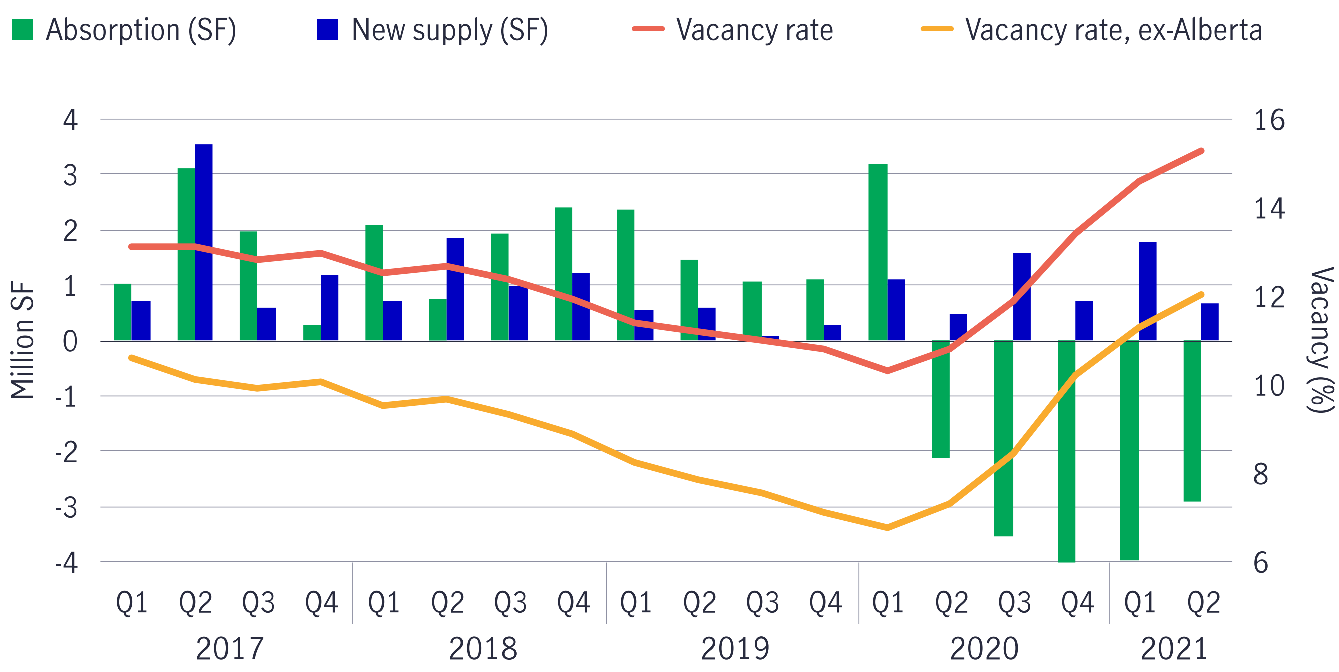
Since March 2020, the economy has experienced an unprecedented transformation as millions of Canadians were told to work from home due to the pandemic. As of June 2021, Statistics Canada reported 4.7 million Canadians were currently working the majority of their hours from home—a drop of 400,000 people over the prior month. Nationally, absorption continued downward, reaching –0.6% of inventory over the second quarter of the year. While negative, this is an improvement from Q1 2021, when absorption dropped by 0.8% of inventory.[6] Although expectations remain pessimistic for the remainder of 2021, it's encouraging to be trending in the right direction.

Canada's open and welcoming approach to immigration has increasingly made it a top destination for highly skilled foreign workers. Perhaps the biggest beneficiaries of Canada's progressive stance on immigration have been tech companies, which are traditionally in-office businesses that regularly have to compete to attract top talent. In the first six months of 2021, Canada invited in nearly double the amount of permanent residents compared with the first six months of 2019 through the Express Entry program.

As the pandemic kept office workers home, the initial reaction from many office tenants of varying sizes was to try to sublet excess office space. While this trend has permeated most office markets in Canada, Toronto, and Calgary, it does represent 71% of total sublet space nationwide. For Calgary, this isn't a new story, but rising energy prices could provide a much-needed boost to office fundamentals. On the other hand, Toronto's office market entered the Great Lockdown in a historically strong position, and recent headlines regarding notable sublet withdrawals could signal the early stages of a recovery.

Since March 2020, opinions surrounding the future of the office have run the gamut of acceptance and rejection but, gradually, appear to have landed somewhere in the middle, with the majority seeming to favour a hybrid model going forward. Looking to our neighbours from the south, big players in the technology and financial services industries have done an about-face, with many of the loudest voices in the room touting the importance of physical office space. While productivity has dominated the conversation, as employees feel equally productive from home as in the office, certain intangibles such as company culture and creative problem solving are more difficult to measure, and perceived inefficiencies are reminding industry leaders why they'd seen value from investing in high-quality workspaces before the global crisis.

Office supply/demand



Source: CBRE Research, Manulife Investment Management, as of Q2 2021.

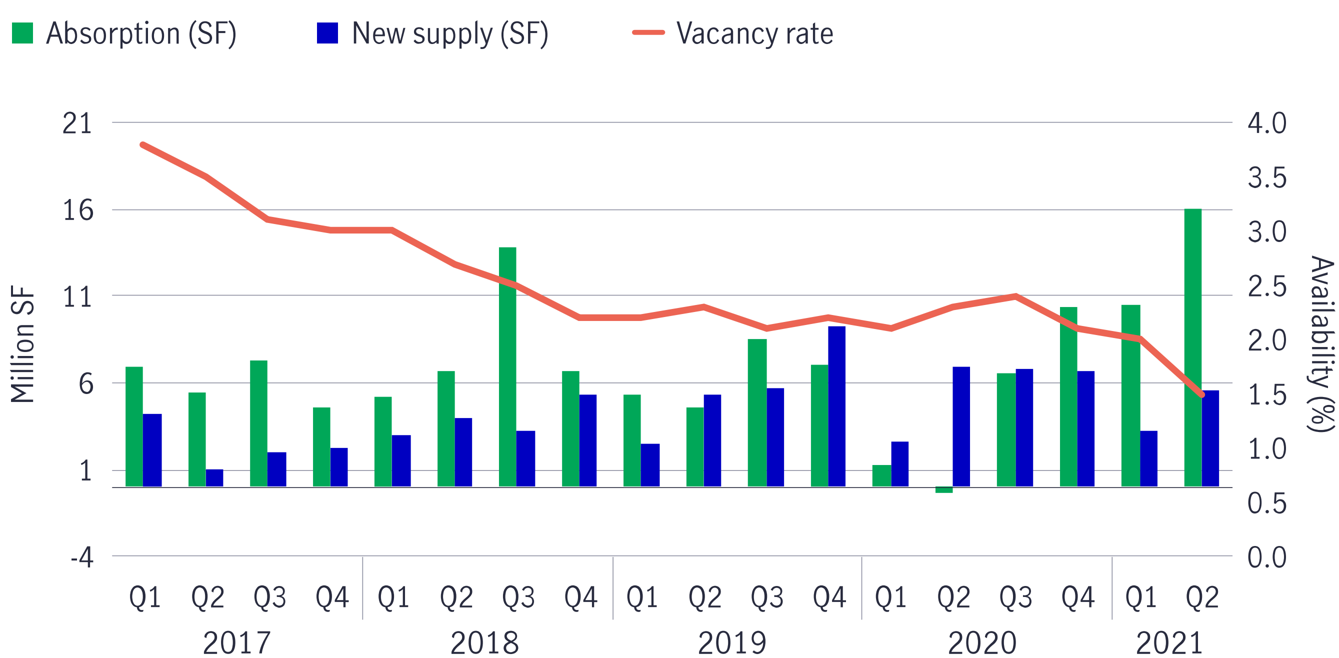
Industrial market

If there's been one consistent story line for commercial real estate throughout this pandemic, it's that industrial has been the belle of the ball. For the first time ever, the vacancy rate has gone below 2% nationwide, and by a substantial margin—dropping to 1.5%. Not surprisingly, this record-low vacancy rate came with record-high absorption of 16 million SF in the second quarter. To put this in perspective, if we stopped counting absorption for the rest of the year, 2021 would still be the second-strongest year of industrial absorption in Canada since tracking began in 2002.

At the root of the supply issues facing most Canadian industrial markets are land constraints, especially in Toronto and Vancouver, where this has been a persistent issue for years. And compounding the problem of short supply of developable land is Canada's favourite conversation topic: the red-hot housing market. For many years, but even more so since the beginning of the pandemic, massive demand for housing has fueled high returns on residential development in and around major population centres, increasing competition for developable land and sending land values higher. For the first time in history, the national average price per acre for industrial land surpassed CAD$1 million per acre, with Toronto jumping up to CAD$1.8 million per acre and Vancouver reaching an astounding CAD$4 million per acre. While developers are continually adding new supply to inventory, the percentage of construction activity as a proportion of inventory, currently sitting at 1.4%, has never surpassed 1.5% in any given quarter in Canada, whereas the United States is typically more proactive in its supply response, with an average of 2.2% of inventory.[7]

Early indications that Canada's economy is poised for a bounce back in the second half of 2021 could come with another tailwind for industrial real estate. June data for the Ivey Purchasing Manager's Index (PMI), a measure that's widely regarded as a leading indicator of economic activity in Canada, jumped up to 71.9 from 64.7 in May, which is just below a 10-year peak of 72.9 reached in March 2021.[8] Considering that a reading of 50 represents purchasing remained the same month over month (below 50 denotes a decrease), a score of 71.9 infers that businesses activities are increasing across the main five categories: purchases, employment, inventories, supplier deliveries, and prices. A strong PMI is a great sign for manufacturing-related real estate and, when paired with the widespread growth in eCommerce, along with the disequilibrium in supply and demand, it's expected to reinforce the positive outlook for industrial real estate across Canada.

Industrial supply/demand



Source: CBRE Research, as of Q2 2021.

Retail market

Retail has had more than its fair share of pandemic-induced woes as many parts of the country have periodically been thrown into lockdown, which overwhelmingly appeared to target smaller retailers with less diverse product compositions. The good news is that after lagging much of the developed world in vaccination rates, Canada ramped up efforts in the second quarter, with about 68% of Canadians having received one dose by June 30; about 36% of the country is now fully vaccinated.

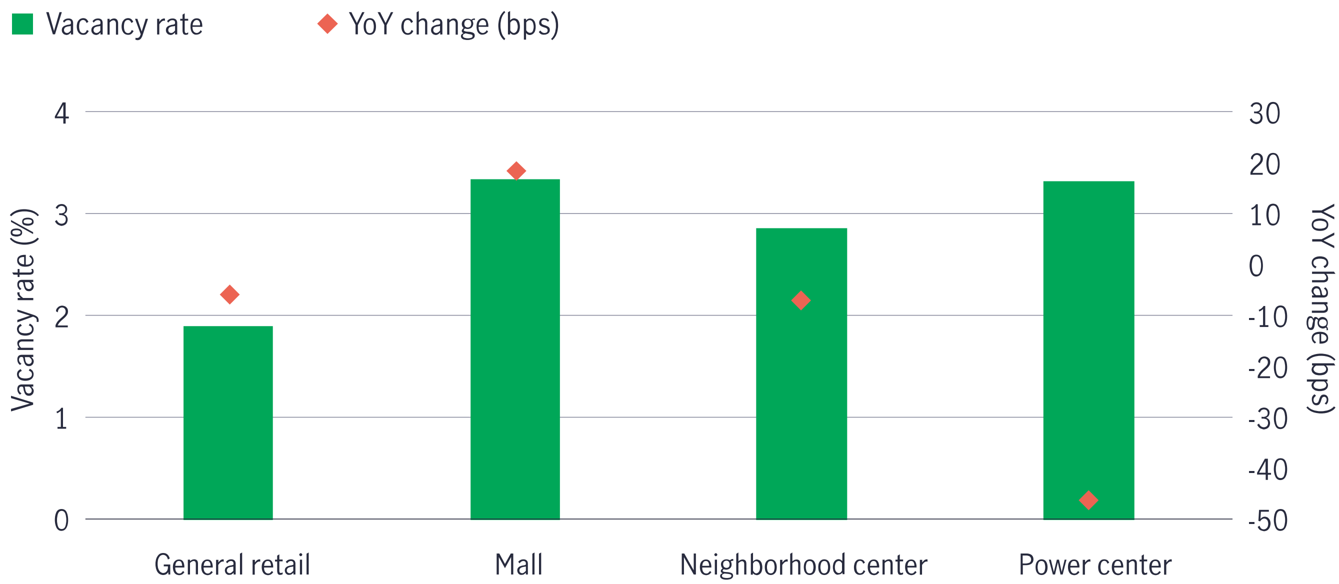
One overarching trend permeating retail real estate in Canada has increasingly been the shift from pure retail to mixed use. While the pandemic didn't create this trend, it seems to have sped up the transition. This is exemplified with Q1 2021 new retail construction starts at near all-time lows, with only 338,000 SF breaking ground.[9]

Retail employment has been on a roller coaster since March 2020. As restrictions eased heading into summer 2021, the number of people working in the retail trade recovered, with 75,000 (3.4%) net new jobs created in June, following declines of 84,000 and 29,000 in April and May, respectively.

Restrictions resulting from the third wave of coronavirus infections across Canada led to retail sales dropping by 5.7%, to CAD$54.5 billion, in April, the biggest single-month drop since the initial onset of the pandemic.[1] Preliminary estimates indicate that a further drop of 3.2% is likely for May, but official figures won't be available until mid-third quarter. As the country—specifically Canada's most populated province, Ontario—begins to reopen, there's a potential looming stimulus, as the return of nonessential services and in-person shopping could unleash a wave of spending.

With stay-at-home policies preventing would-be shoppers from physical retail spaces during the pandemic, shopping patterns shifted to online. Since March 2020, the share of domestic online sales as a percentage of total retail sales has averaged 7.1% per month, compared with pre-global crisis sales at 2.9%.[10] In reality, the percentage of purchases taking place online is likely understated, as this figure excludes purchases made by Canadian consumers from foreign-based retailers.

Retail national vacancy rates by segment



Source: CoStar, as of June 31, 2021. National data represents aggregate data for markets tracked by CoStar, which include Calgary, Edmonton, Ottawa, Toronto, and Vancouver.

Multifamily market

The pandemic has weighed down many parts of real estate markets, but not even a global health crisis—which at first sent renters fleeing densely packed urban core apartments—could stifle the long-term expectations of the resilient multifamily asset class. As vaccination rates have increased, it appears that the supposed urban exodus may have been overstated. Rental rates in major population centres seem to be trending up as companies are finding that their return-to-office plans and aspirations of permanent work from home appear to be unrealistic for most, as many influential corporations reiterate the importance of physical office space. More than likely, workers will continue to prefer to be located near their place of work as even an occasional long commute may seem unappetizing.

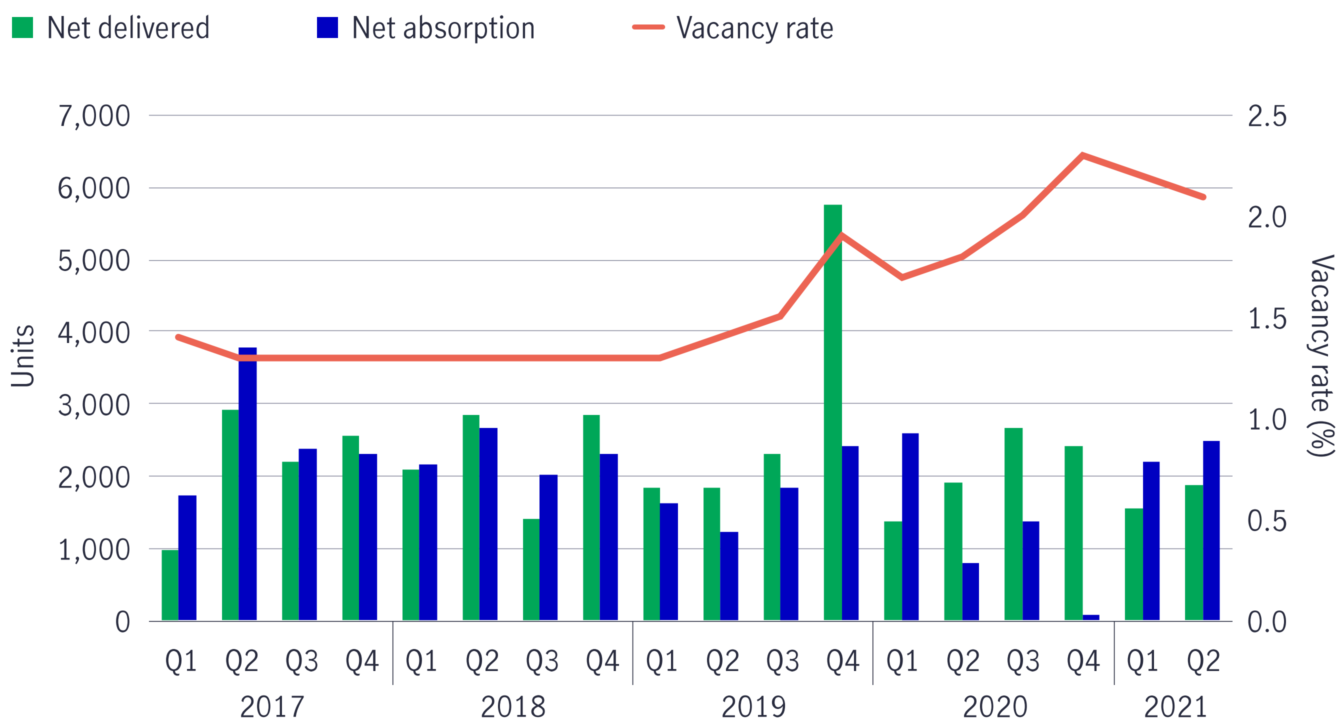
The federal government has proactively enacted accommodative benefits aimed at helping Canadians most affected by the pandemic throughout the crisis. First it was the CERB—Canada Emergency Response Benefit—which ended six months ago, and then it was the CRB—Canada Recovery Benefit—which is ending in September 2021. Does this signal the end of government relief programs? In our view, no, at least not at this point, as recently the federal government has expanded the long-standing EI—

Employment Insurance—program from 24 weeks of coverage up to 50 weeks and lowered the earnings threshold with the goal of increasing accessibility. These recovery benefits have helped tenants pay rent, and with Ontario's eviction ban recently being lifted, residential landlords are better positioned to remedy issues with rent collection.

The Trudeau administration remains committed to increasing annual immigration targets, with the goal of making up for 2020's shortfall by adding 1.2 million new permanent residents by the end of 2023. As the average working age population continues to decline in Canada, immigration is key to population growth.

As Canada's residential real estate affordability issues continue to make headlines, the red-hot housing market is attracting a growing amount of interest from institutional and large-scale investors. This has faced an increasing amount of backlash, as individual investors, especially first-time home buyers, are reaching further into their pockets to attain the holy grail that's home ownership. On a micro level, the impact of increased competition from buyers, combined with reduced supply brought on by inflated development costs, high land values, and lengthy permitting processes, compounds the imbalance and perpetuates affordability issues. A recent release by Statistics Canada detailed that household mortgage debt increased at the fastest pace since 2010, reaching CAD$1.7 trillion in April 2021, which was an increase of CAD$17 billion and represented the largest single-month increase ever recorded. As many Canadians feel priced out of their local markets, we believe this will inevitably keep more people in the rental pool long term.

Multifamily supply/demand



Source: CoStar, as of Q2 2021. National data represents aggregate data for markets tracked by CoStar, which include Calgary, Edmonton, Ottawa, Toronto, and Vancouver.

1 "Labour Force Survey," Statistics Canada, June 2021. **2** Bank of Canada, June 9, 2021. **3** "Forward guidance: Our weekly preview" RBC Economics, July 9, 2021. **4** CoStar, as of May 31, 2021. **5** MSCI/REALPAC Canada Annual Property Index, as of May 31, 2021. **6** CBRE Research, as of March 31, 2021. **7** CBRE Research, as of May 31, 2021. **8** Ivey Purchasing Managers Index, June 2021. **9** CoStar, as of June 31, 2021. **10** Retail e-commerce sales, Statistics Canada, April 2021.

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