MARKET REPORT

OFFICE

Toronto Metro Area

IPA INSTITUTIONAL PROPERTY ADVISORS
A DIVISION OF MARCUS & MILLICHAP, BROKERAGE

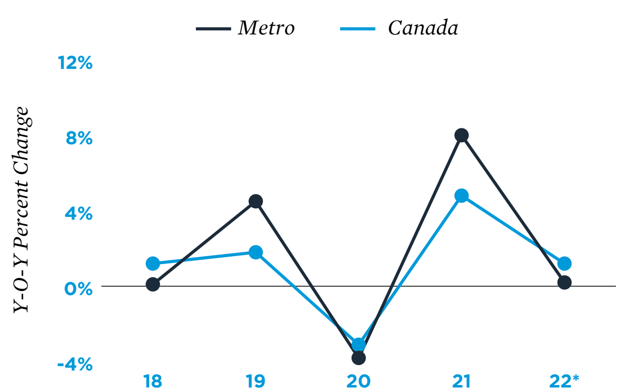
3Q/22

Economic Uncertainty Eases Office Momentum After Encouraging Signs Earlier in the Year

Slowing economy dampens office recovery. During the second half of 2021 and the first quarter of 2022, the Toronto office market showed positive signs toward the beginning of a recovery. Net absorption was positive and vacancy decreased for the first time since 2020, falling by 10 basis points between September and December of 2021. However, with economic uncertainty on the horizon, high inflation and rising interest rates, companies are once again taking a wait-and-see approach when it comes to future office needs. Additionally, Toronto's office recovery was being led by technology companies leasing out large volumes of space, as the metro has built a reputation as one of the hottest technology cities in North America, ranking third in concentration of talent. However, due to economic headwinds facing the national economy, many tech companies are pausing hiring or going through layoffs, resulting in slower office demand. Nonetheless, technology, finance, insurance, real estate and the business service sectors are driving leasing activity in the downtown market, while technology and life sciences lead the way in the suburban markets.

New developments enter at an unfavourable time. An influx of new supply came to market during the health crisis, causing fundamentals to weaken at a quicker pace. Although most new supply is pre-leased, it is resulting in significant availabilities in Class B and C assets, which are more challenging to lease. With companies moving to high-quality space in the hopes of attracting talent and luring people back to the office, it is resulting in some older, lower-tier spaces becoming obsolete, as work from home has slowed demand for these assets.

Employment Trends



* Forecast

Sources: Statistics Canada; CoStar Group, Inc.; Altus Data Solutions

Office 2022 Outlook

5,700
JOBS
will be created

EMPLOYMENT:

National unemployment remains low, but Toronto is still above its 2019 level, at 5.9 per cent as of August. This indicates slack in the labour market. However, with economic uncertainty, job creation will begin to soften in the coming quarters, resulting in low employment growth throughout 2022.

3,200,000
Sq. Ft.
will be completed

CONSTRUCTION:

The majority of completions in 2022 are in the downtown core. Robust tenant demand for modern high-quality space is resulting in a large percentage of these buildings being pre-leased before delivery. However, oversupply remains a concern.

190
BPS
increase in vacancy

VACANCY:

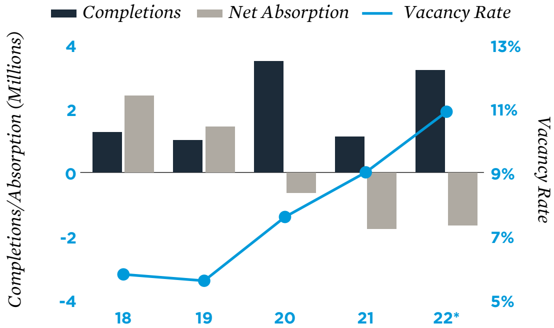
Vacancy is expected to increase to 10.9 per cent by year-end, due to economic headwinds and an influx of new supply entering the market at a difficult time. Vacancy is higher in suburban markets. However, it is increasing at a more moderate pace.

9.4%
INCREASE
in asking rent

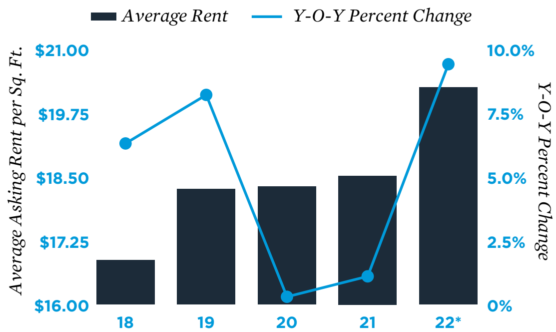
RENT:

The average asking rent will end the year in the $20.00 to $25.00 per square foot range. This is driven by new supply entering the market, plus the flight-to-quality trend. The downtown average asking rent will be roughly $35.00 per square foot, and suburban space will be in the $15.00 to $20.00 per square foot range.

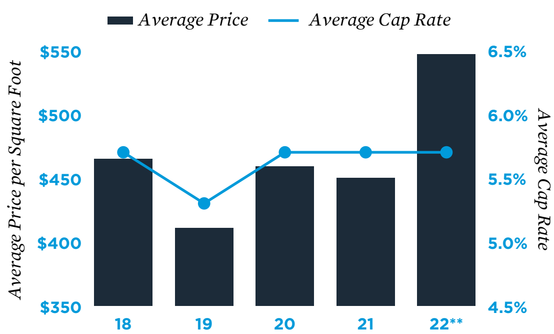
Supply and Demand



Rent Trends



Sales Trends



** Forecast ** Through 2Q*

Sources: CoStar Group, Inc.; Altus Data Solutions

2Q 2022 - 12-Month Period

CONSTRUCTION

2,125,000 sq. ft. completed

- Construction was down over the trailing-12-month period, mostly caused by supply chain disruptions, higher input costs and labour shortages. This caused development timelines to be pushed to the following year.
- Menkes delivered The Hive and The Exchange located on Toronto's Waterfront, combining to bring nearly 482,000 square feet to market.

VACANCY

110 basis point increase in vacancy Y-O-Y

- Due to ample new supply hitting the market during the health crisis, vacancy rose faster than most other major metros in Canada.
- With major tenants leaving existing buildings for new, high-quality developments, the market became saturated with older, less appealing availabilities, resulting in large blocks of harder to lease space sitting on market.

RENT

4.2% increase in the average asking rent Y-O-Y

- Despite the office market facing headwinds, the average asking rate increased throughout the trailing-12-month period due to increased downtown availability, coupled with top-of-the-line new supply being delivered.
- The average asking rent also grew, due to owners' hesitancy to negotiate lower values. Instead, many are offering large incentive packages.

Investment Highlights

- The first half of 2022 has so far been a historic year for transactions. In the first two quarters, the Greater Toronto Area has experienced more than 150 sales — a 52 per cent increase year-over-year, and a 78 per cent increase from 2019. Roughly 40 per cent of total dollar volume was by Canadian private investors, and 38 per cent was by foreign private investors, suggesting some belief the Toronto office market will recover. This marks a shift in dynamics, as prior to the pandemic, the bulk of transactions were made by institutional players. Now, more private buyers are involved as institutional players are strategically disposing their assets. A sizable portion of the foreign investment was one transaction, with the purchase of Royal Bank Plaza by Pontegadea, a company owned by the founder of Zara.
- The average price per square foot has increased over the past five years, rising by roughly 17 per cent since 2018. Cap rates have also remained constant at 5.7 per cent, the same as 2018. In 2019, when office demand was at historic levels, cap rates hit an all-time low of 5.3 per cent, but were quickly pushed back to 5.7 per cent in 2020, due to the health crisis.
- Toronto proper has led the way in investment activity. However, more suburban markets like Mississauga have seen an uptick in transaction volume, increasing by roughly 50 per cent since 2020.

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