Office Market Was Stabilizing but a Slowing Economy is Impeding Momentum

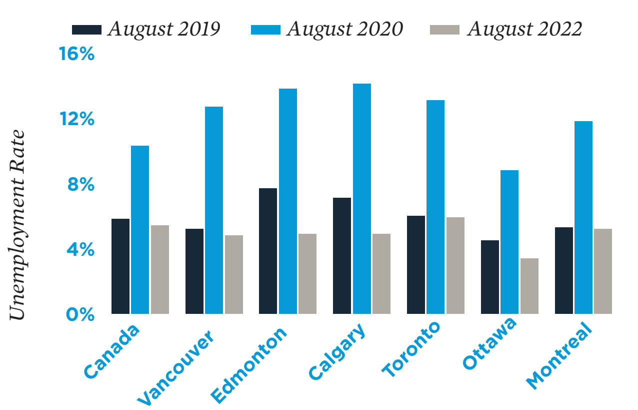
Leasing activity elevated in the first quarter of the year. Canada's office market began to recover following a difficult 18-month period, experiencing positive net absorption in the final quarter of 2021 and the first quarter of 2022. This was the first time Canada has recorded an uptick in leasing activity since early 2020, but economic uncertainty has once again stalled momentum. Nonetheless, with COVID-19 largely abated, suburban markets, Class A offices, and the Vancouver area are bright spots in the office landscape. However, urban cores continue to lag behind suburban markets due to the slowing economy and tech-sector uncertainties. With a possible recession on the horizon, technology companies are starting to freeze hiring, or in some cases, begin layoffs, translating into softer demand for downtown office space. This is especially true for Toronto, which has one of the largest concentrations of tech talent in North America, causing downtown vacancy to increase by 60 basis points through the first half of 2022, mostly in lower-tier assets. In contrast, suburban markets improved and all other major markets outside of Toronto have lower vacancy in the suburbs than in their urban cores.

Flight-to-quality a key theme across all cities. While suburban markets are outperforming downtown cores as a whole, new downtown space is continuing to be absorbed. Owners and tenants realize that ample amenities, personal space and proximity to public transit are a necessity to attract employees back to the office and endure long commute times. While some elements of remote work may be here to stay, employers and employees still see the benefit of occupying office space, however, the way the office is used will likely change in the future towards a more collaborative and meeting-driven environment.

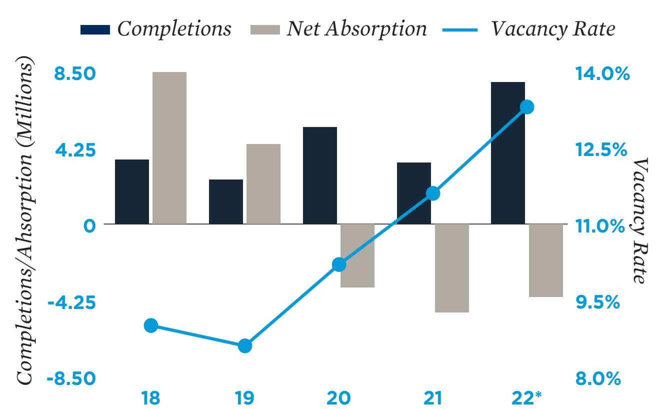
Vancouver office market is the top performer in Canada. While economic headwinds have slowed tech companies leasing activity in Toronto, the opposite has happened in Vancouver as this sector has increased their footprints in the suburban markets as well as the downtown. One example is Microsoft, who expanded its original lease as well as pre-leased additional space. The expanding presence of technology companies is a primary reason Vancouver has the lowest vacancy rate amongst all major metros. Nonetheless, Canada will see a large amount of new supply in 2022, with a significant share in Vancouver. The metro has the second most construction activity in North America. While the majority of this new space is pre-leased, there will still be large availabilities entering the market and it is anticipated fundamentals will likely weaken in the short-term. However, due to the flight-to-quality trend, this new space should quickly be absorbed. Nonetheless, this comes with risk, as older, obsolete stock will become available as tenants move out.

Investment activity remains robust. Although uncertainty surrounds the office market, investors continue to have cautious optimism towards a recovery and remain active as long-term fundamentals will likely improve with return-to-office strategies becoming more clear. Total dollar volume transacted in the first half of 2022 is up 250 per cent from 2021 and 35 per cent from 2019, when office vacancy was at historic lows. The difference is that the majority of purchases are now by private Canadian investors, not institutional players, as they are diversifying and globalizing their portfolios in order to mitigate risk and expand into new markets.

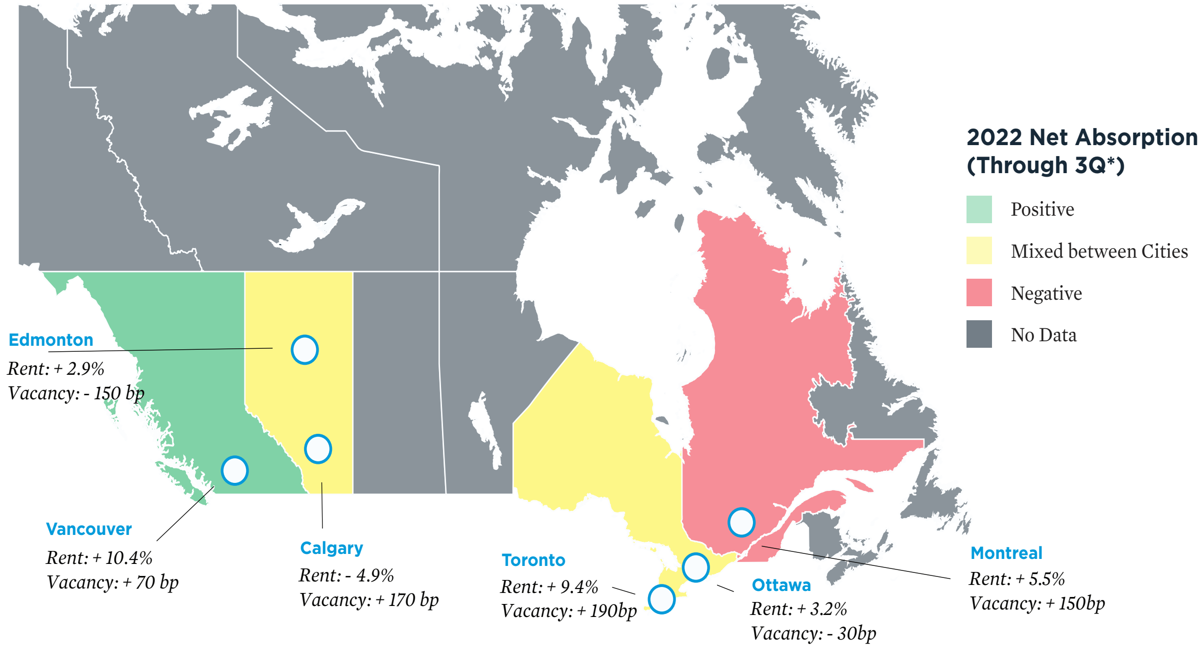
Unemployment Trends



Supply and Demand



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



2022 Forecasted Rent Growth and Vacancy Change

** Year-to-Date, with preliminary 3Q estimates*
Sources: IPA Research Services; Altus Data Solutions, CoStar Group, Inc.

WESTERN CANADA

- **Vancouver, British Columbia:** The office market is signaling the beginning of a recovery with major lease transactions in the first half of 2022. Microsoft and Lululemon combined to lease roughly 520,000 square feet in the downtown core. However, with the second most office construction activity in North America, vacancy is likely to rise through the rest of the year as not all developments are fully pre-leased. This is only expected to have short-term impacts, as strong leasing activity and the flight-to-quality trend should result in these new Class A assets being leased throughout the upcoming year.
- **Edmonton, Alberta:** Due to the relatively diverse tenant mix, Edmonton is not as impacted by changes in oil prices, resulting in some stability within the office market. However, office fundamentals were negatively impacted due to remote work and new supply entering just before the global health crisis. Nonetheless, no developments have come to market since those in late 2019, which will help long-term fundamentals as net absorption has been positive in 2022, resulting in cautious optimism towards the metro's office market.
- **Calgary, Alberta:** The recovery of oil prices has historically translated into robust office demand. However, energy companies are currently using elevated profits for share buybacks and increased dividends, instead of re-hiring and expanding capacity due to the price volatility within the market. Without government guarantees, companies deem investment in capacity expansion too risky. However, Calgary is beginning to diversify its economy away from oil. With large tech companies like AWS, IBM and Infosys bringing innovation hubs to the metro in 2023, the office market is beginning to gain momentum as leasing activity has returned to pre-pandemic levels.

EASTERN CANADA

- **Toronto, Ontario:** The office sector showed signs of a recovery in the second half of 2021 and the first quarter of 2022, which was mostly driven by the technology industry. Now, with rising interest rates and the economy beginning to slow, tech firms, and other companies, have paused hiring and have taken a wait-and-see approach in regards to their future office needs. The office sector has also been hindered by an influx of new supply entering during the pandemic. While most of this space is pre-leased, it is resulting in large availabilities in Class B and C assets, which are more challenging to lease.
- **Ottawa, Ontario:** The office sector has remained relatively stable throughout the health crisis due to the large presence of the federal government and the technology industry. Kanata, a suburban market, has been one of the most robust areas since early 2021 as prior to the dot-com bubble, the suburban market was becoming a major tech hub in Canada. With this sector growing during the health crisis, tech companies returned to the suburban market due to the presence of Class A office space, which fits the national flight-to-quality trend.
- **Montreal, Quebec:** Leasing has begun to gain momentum in the downtown, specifically in upper-tier properties. While absorption is still negative, it appears the market is reaching an inflection point, as the magnitude is beginning to subside. Montreal's suburban markets have remained relatively stable with an abundance of Class A properties, fitting well with the national flight-to-quality trend. Moderna has also announced they will be building a bio-manufacturing lab in Laval, further elevating demand in the suburbs as it is expected that additional companies will follow, turning the Montreal suburbs into a life science hub.

Office Momentum Slows in the Face of Rising Interest Rates and a Possible Recession

2022 Forecast

CANADA EMPLOYMENT

1.2% increase Y-O-Y

- Employment growth began the year strong, with just over 220,000 jobs added throughout the first half of the year, however, rising interest rates and a possible recession has slowed hiring. Still, the unemployment rate should remain below the pre-pandemic level.

CANADA CONSTRUCTION

7,900,000 square feet completed

- Construction will reach levels not witnessed since 2017, with most new development in downtown markets. This uptick is mainly caused by construction timelines being pushed during the global health crisis due to supply chain disruptions, rising costs and labour shortages.

CANADA VACANCY

170 basis point increase Y-O-Y

- Vacancy should end the year at 13.3 per cent. This is being driven by the influx of new supply that is not fully pre-leased and the fight-to-quality trend that is causing older, obsolete space to enter the market, which is harder to lease with the prevalence of remote work.

CANADA ASKING RENT

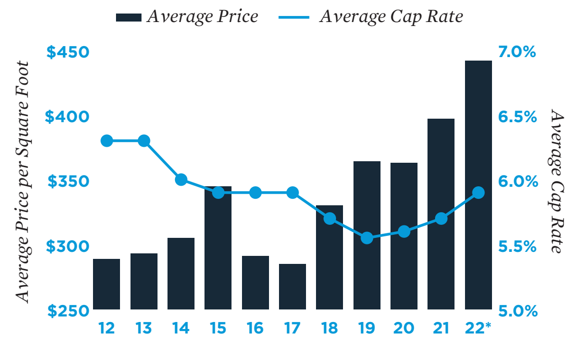
6.6% increase Y-O-Y

- Although net absorption has been negative and vacancy is rising, the average asking rent is expected to increase to $18.85 per square foot by year-end. This is being driven by the influx of new, Class A supply, coupled with the national flight-to-quality trend.

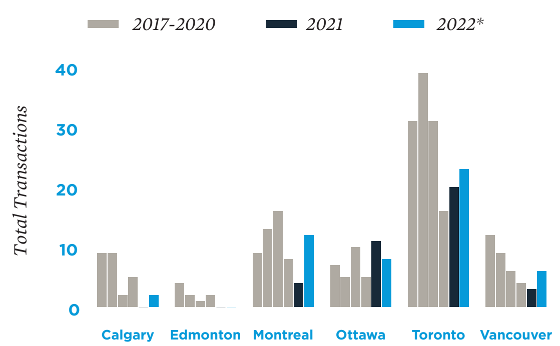
2022 INVESTMENT OUTLOOK

- Throughout the first two quarters of 2022 and with preliminary estimates for the third quarter, Canada's office market has experienced roughly 450 transactions, for a total dollar volume of $5.7 billion. The office market began to experience a change in dynamics throughout 2022, as just over 50 per cent of total dollar volume traded has been by private Canadian investors. This differs from pre-pandemic times, where institutional players usually held the largest share of transactions. However, with the rise of remote work, institutional owners have begun to diversify and globalize their portfolios in order to mitigate risk and expand into additional markets.
- The two largest office transactions throughout the first half of 2022 were both in Toronto. The first was Oxford Properties sale of Royal Bank Plaza, one of Toronto's most prestigious office towers, to the Pontegadea Group, the real estate company owned by the founder of the clothing brand Zara, for nearly $1.2 billion. The second was BentallGreenOak's sale of 121 King Street West to Crestpoint Real Estate Investments for just under $380 million. Both properties are located in the heart of downtown Toronto and have excellent access to the city's public transit system as well as the underground PATH network.
- A significant amount of infrastructure projects are underway throughout Canada's major metros. These include the Ontario subway line in Toronto, the Broadway corridor subway in Vancouver, and the Réseau Express Métropolitain in Montreal. These projects are meant to increase accessibility to Canada's downtown cores as well as connect suburban locations to urban centers. These infrastructure projects are likely to result in ample mixed-use investment developments in the coming years.

Investment Sales Trends



Office Transactions Over $20 Million



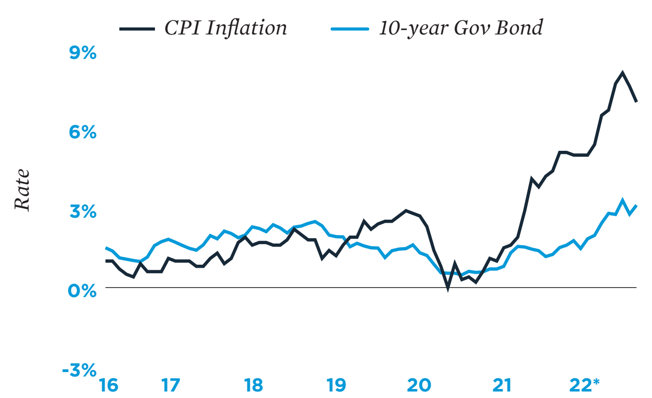
* Trailing 12-months through 2Q
Sources: Altus Data Solutions; CoStar Group, Inc.; Statistics Canada

The Bank of Canada's Inflation Response Tightens Underwriting for Investors

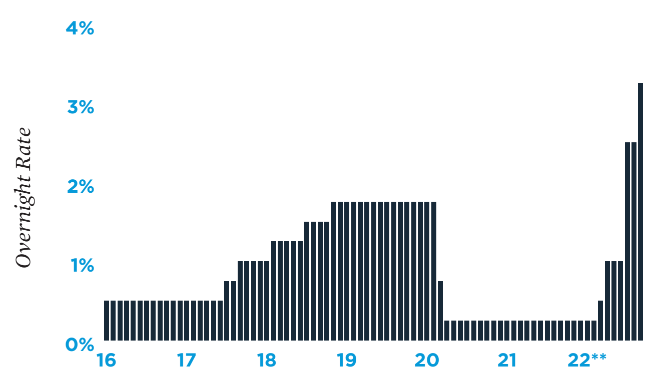
Bank of Canada makes fighting price increases the number one priority, interest rates rising as a result. Persistently elevated inflation and strong job growth through the first half of 2022 has kept the BoC firmly committed to raising interest rates. At its July meeting, the BoC increased the overnight rate by 100 basis points, the largest single hike in nearly 25 years, and followed again in September with a further 75-basis-point increase. Now sitting at 3.25 per cent, the BoC is signaling its intention to bring the overnight lending rate to around 3.5-4.0 per cent. These actions are having notable upward impacts on both short-term and long-term interest rates, affecting equity and bond markets. Bond yields have been increasing, with the two-year note surpassing the 10-year note by nearly 70 basis points. While a persistent inversion in the yield curve of these two metrics has served as a recession predictor in the past, capital migration amid the dynamic investment climate is contributing to this current yield disparity. However, the spread between the three-month and 10-year notes, a more reliable recession predictor, has also inverted, resulting in a more bleak economic outlook, which may mean the BoC is nearing the end of their aggressive monetary policy. Ultimately, the BoC hopes to curb price increases with higher borrowing costs without derailing economic growth.

Capital available with tighter underwriting, likely to impact sales activity to some extent. Rapidly tightening monetary policy is prompting lenders to adjust quoted rates and widen spreads. This is especially true of financiers who benchmark to credit markets, including life insurance companies and CMBS sources, but balance sheet lenders, such as banks, will also likely follow suit over time. Capital continues to be readily available if borrowers can meet these tighter terms. Lending rates for commercial investment transactions are pushing into the mid- to upper-5 percent range on average and trending higher as of late September, putting downward pressure on leverage. Borrowers with established relationships with financiers and experience in the sector may be able to secure more favorable terms, although individual asset quality and location criteria continue to factor in substantially. Tighter terms may impede investment sales to a degree as some investors absorb the higher lending rates or reduce their leverage. More buyers may turn to tertiary metros with strong population growth, where cap rates tend to be higher and property performance is strong. While institutional investors tend to favor larger assets in major metros, where cap rates are lower, these players may be able to secure capital at lower rates.

Canada's Inflation Rate



Bank of Canada Overnight Rate



** Through August; ** Through September 7, 2022*
Sources: IPA Research Services; Altus Data Solutions; Bank of Canada; Statistics Canada

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