NATIONAL REPORT

CANADA INDUSTRIAL

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

2Q/23

Surge in New Supply to Drive Temporary Uptick in Vacancy; Long-Term Demand to Remain Healthy

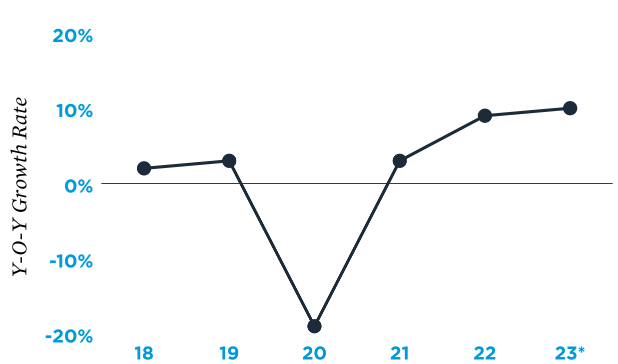
Outlook for industrial sector remains positive. Canada's economy grew at a healthy pace in the first quarter of 2023. Real GDP remained in expansion mode, thanks to robust performance recorded in January. Over 200,000 jobs were created within the first three months, which helped maintain the unemployment rate near a historic low. More importantly, output in sectors that often utilize industrial spaces grew at a healthy rate. GDP in the transportation and warehousing sector, for instance, registered an average rate of increase of 11 per cent year-over-year between January and February, which far outpaced total GDP growth. This strong momentum aided a 57 per cent annual increase in net absorption in the first quarter. With an increasing likelihood of a soft landing for the Canadian economy in 2023, demand in the industrial sector should be well supported. The national average vacancy rate will tick up slightly amid a surge in supply, but should still end the year sub-2 per cent.

Elevated demand to persist in coming years. The need for a better logistics and transportation network will continue to drive industrial demand in Canada, as companies are putting greater importance on nearshoring amid changing consumer behaviour and rising global geopolitical risks. The Montreal Port Authority, for example, has received $75 million from the government of Québec toward its expansion project in Contrecoeur to build a new container terminal. Edmonton International Airport will also expand its cargo and logistics capacity in order to better serve trade routes within North America. Additionally, Southwestern Ontario is positioned to become an electric vehicle battery manufacturing hub with government and investor support, which is driving future demand for industrial space. Following Stellantis' $4.9 billion, 4.5-million-square-foot EV battery plant in Windsor, Volkswagen will also establish its first North American EV battery plant in St. Thomas.

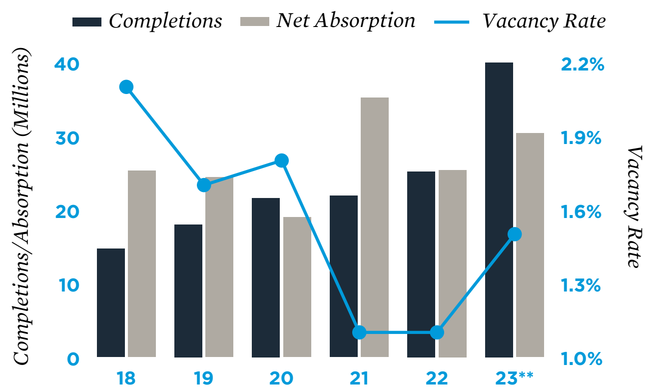
Vacancy crunch accompanied by substantial rent growth. As demand for industrial space skyrocketed over the past few years, vacancy rates were compressed to a multi-year low. Metros in Alberta experienced the largest drops in vacancy, due to a relative abundance of available stock prior to the pandemic. In traditionally tight markets, such as Toronto and Vancouver, the volume of unoccupied inventory remained at extremely subdued levels. This low vacancy across Canada, coupled with fast-rising construction costs, led to double-digit percentage increases in occupancy cost over the past four quarters. The national average asking rent rose to $15 per square foot in the first quarter of 2023. Toronto and Southwestern Ontario saw the steepest rent increases, with the current rates standing roughly 70 per cent above the pre-pandemic level.

Construction activity on the upswing. New supply lagged behind demand growth over the past three years as labour shortages, rapidly rising construction costs and supply chain disruptions delayed development timelines. However, developers remained active to capitalize on the resulting tight market. The current under-construction pipeline in British Columbia, Alberta and Ontario combined has now reached above 30 million square feet, which is 50 per cent greater than the volume recorded at the end of 2019. This year, a large portion of this under-construction stock will be finalized. Calgary will see the greatest rate of increase in completions among major metros, at 82 per cent higher than the 2022 level. New openings will total 15 million square feet in Toronto, which is the highest level recorded since at least 2008. With the help of this surging new supply, rent growth will moderate to a more sustainable level, and vacancy will end the year 40 basis points higher at 1.5 per cent. Nonetheless, with demand expected to remain robust, coupled with almost 50 per cent of the construction pipeline pre-leased, upward pressure on vacancy will be limited, keeping long-term fundamentals healthy.

GDP in Transportation and Warehousing

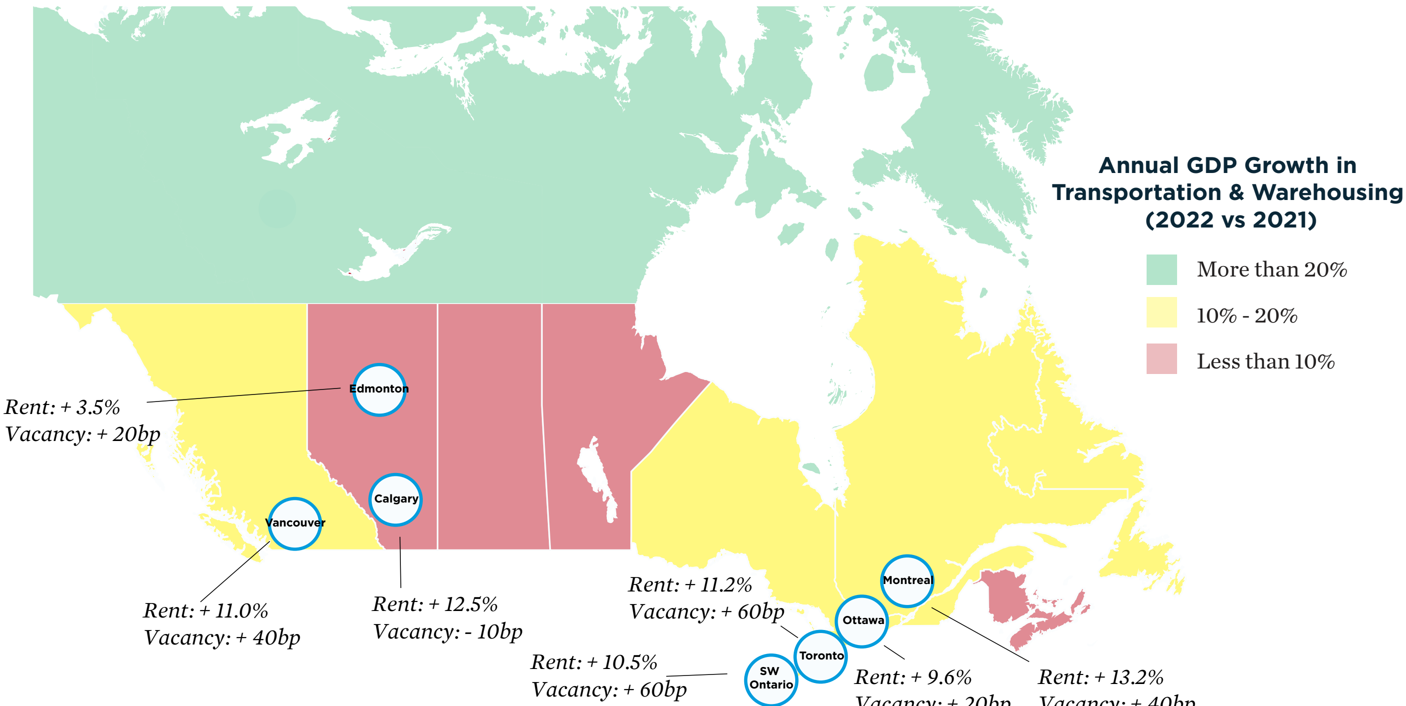


Supply and Demand



* *As of February 2023, 12-month rolling average; ** Forecast*
Sources: IPA Research Services; Altus Data Solutions; CoStar Group, Inc.; Statistics Canada

Overview of Canada's Major Markets



2023 Industrial Rent Growth and Vacancy Change Forecasts

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

WESTERN CANADA

- **Calgary, Alberta:** The average annual net absorption between 2020 and 2022 nearly doubled the pre-pandemic level amid significant growth in e-commerce and demand spillover from the tight Vancouver market. This led to Canada's largest drop in industrial vacancy recorded within this period. The strong demand has also spurred speculative development, which will push completions to 5.5 million square feet in 2023. Despite this increase in new construction, vacancy will continue to remain below 2 per cent.

- **Edmonton, Alberta:** Edmonton's industrial vacancy decreased 110 basis points in 2022, but compared to other regions, the metro still offers a more balanced market with an above-3 per cent availability. As Alberta's economy is expected to remain healthy in 2023, demand for industrial space will be well supported. The province's Hydrogen Roadmap initiative, a plan to build a low-emission hydrogen economy with access to the global market, will bode well for the metro's future industrial demand.

- **Vancouver, British Columbia:** Already a low-vacancy market with availability approaching 1 per cent preceding the global health crisis, Vancouver saw its vacancy rate tighten further over the past three years. Many submarkets, such as Langley Township and Maple Ridge, were practically at full occupancy at the end of the first quarter of 2023. This substantial demand and a lack of usable land have prompted developers to build multi-storey and mixed-use projects, which will provide slight short-term relief to some tenants searching for space.

EASTERN CANADA

- **Montreal, Québec:** Rapidly rising interest rates impacted both leasing and construction activity during the final months of 2022, which led to a 40-basis-point increase in vacancy. However, industrial demand got off to a good start in 2023 as interest rates began to stabilize. Speculative development will also translate into a sizable increase in completions, sending vacancy above 2 per cent this year.

- **Ottawa, Ontario:** Optimally located between Toronto and Montreal, Ottawa continues to attract investor and tenant attention. A subdued inventory expansion since 2020 has helped maintain the metro's vacancy rate at low levels. With over 20 properties either planned or under construction, the metro should see higher supply growth in and beyond 2023.

- **Southwestern Ontario:** Substantial leasing activity, due to e-commerce demand spilling over from the GTA and the emergence of EV battery manufacturing, caused rents to increase 34 per cent annually last year. This elevated rent growth will continue, but the rate of increase is expected to ease due to an influx of new supply entering the market.

- **Toronto, Ontario:** As one of Canada's tightest markets, industrial fundamentals will remain healthy as hefty demand stemming from the e-commerce sector and nearshoring continue to keep absorption at elevated levels. In 2023, completions will reach a multi-year high, which will help slow rent growth and provide some relief to tenants. Vacancy will rise above 1 per cent as a result, but could drop again unless construction activity remains elevated for an extended period of time.

Healthy Industrial Fundamentals to Aid an Investment Recovery

2023 Forecast

CANADA EMPLOYMENT

1.0% increase Y-O-Y

- Canada's labour market began 2023 with a healthy start, which may cause employment to grow this year. Nonetheless, gains will likely be front-loaded as elevated interest rates could slow hiring in the latter half of the year.

CANADA CONSTRUCTION

40 million square feet completed

- Most metros will see a notable increase in construction activity, which was spurred by substantial demand over the course of the pandemic. Total completions will register a 60 per cent year-over-year increase in 2023.

CANADA VACANCY

40 basis point increase Y-O-Y

- The vacancy rate will slightly tick up, due to an expected increase in new supply. As availability approached 1 per cent last year, this increase will provide a temporary relief for tenants. The national average vacancy rate, however, will still remain below 2 per cent.

CANADA ASKING RENT

12% increase Y-O-Y

- Industrial rents will continue to increase as demand is expected to remain robust. The national average asking rent will rise above $16 per square foot, which is 48 per cent above the 2019 level. Yet, the pace of increase will soften as vacancy ticks up slightly.

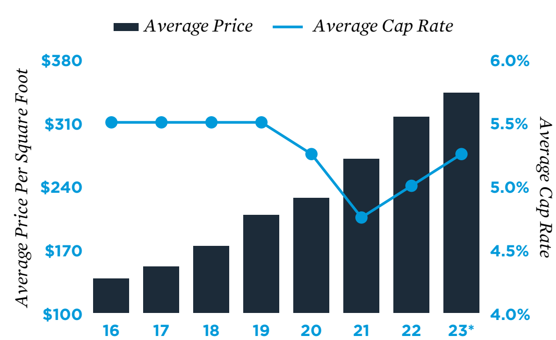
2023 INVESTMENT OUTLOOK

- **Investment activity to rebound as credit conditions improve.** The trailing 12 months through the first quarter of 2023 saw total dollar volume fall 32 per cent, due to a notable slowdown in investment activity beginning in the final quarter of 2022. As the Bank of Canada has hit the pause button on interest rate hikes, financing conditions should stabilize. Given sound fundamentals in the industrial sector, investor confidence should improve, which will likely lead to more robust investment volumes over the second half of this year.

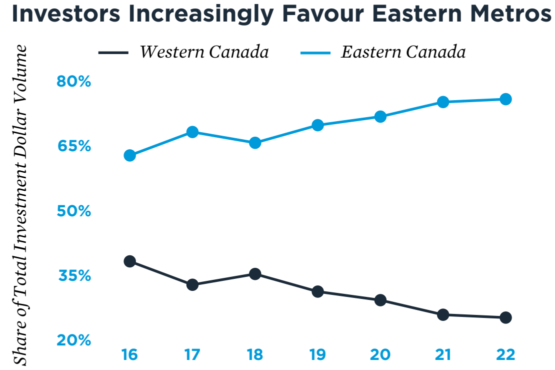
- **Rising cap rates to lose speed as interest rates stabilize.** Yields rose across the board in 2022 on the heels of rapidly rising interest rates. The national average cap rate rose back to the pre-pandemic level, after declining for two straight years. In the first quarter of 2023, cap rates continued on an upward trajectory, but the rate of increase moderated. With greater certainty over Canada's future interest rate path, cap rates should gradually stabilize.

- **Eastern metros attracting an increasing share of investment.** From 2016 to 2022, the share of total dollar volume transacted in Toronto, Montreal, Ottawa and Southwestern Ontario rose steadily from 62 per cent to 75 per cent of total industrial investment in Canada. Compared to Western Canada, these eastern metros experienced more consistent appreciation in property value over the past six years. Additionally, the Great Lakes region is a major population center in North America with elevated e-commerce demand, and hosts key manufacturing hubs in both Canada and the United States. With the localization of supply chains gaining greater importance, eastern metros will likely continue to attract a greater share of investment compared to their western counterparts.

Industrial Investment Sales Trends



Investors Increasingly Favour Eastern Metros



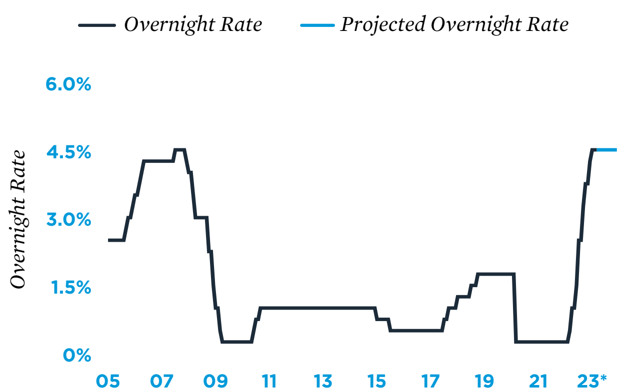
** Through 1Q. Sources: IPA Research Services; Altus Data Solutions; CoStar Group, Inc.; Statistics Canada*

Further Progress Needed to Reach BoC's Comfort Zone; Investor Sentiment to Improve Amid Downside Risks

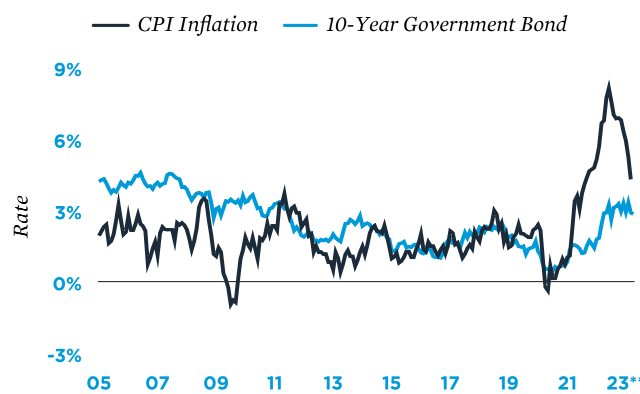
Interest rates to remain unchanged amid fast-cooling inflation, more patience necessary to achieve central bank's goal. Inflation has been on a downward trajectory this year and reached 4.3 per cent in March. This is a welcoming sign for the Bank of Canada as it continues to hold the overnight rate steady to assess the impact of its cumulative interest rate hikes. While inflation has declined from above 8 per cent at a fast pace and is anticipated to drop further to 3 per cent this summer, the BoC has acknowledged that it may take additional time for price growth to fall further and stabilize around its 2 per cent target. For inflation to decrease below 3 per cent, the labour market, which registered strong job gains within the first four months of this year, will need to rebalance with moderating wage growth. Longer-term inflation expectations from consumers and businesses will also have to be anchored at a lower level. As a result, the BoC is expected to hold its overnight rate unchanged at the current level throughout the rest of 2023, in order for the overheated economy to reach a new equilibrium and inflation to centre firmly around 2 per cent.

Clearer interest rate path to drive a recovery in investment, while external risks could lead to a domestic capital crunch. In the first quarter of 2023, investment activity continued on the descent as interest rates reached the highest point since the pandemic. With greater certainty on the interest rate path for the rest of 2023, investment capital that sat on the sidelines over the past few quarters should return to the industrial sector, which is poised for a double-digit percentage rent increase with a sizable inventory expansion in 2023. Total dollar volume, as a result, will likely improve over the next few quarters. On the financing side, lenders continue to exercise caution in underwriting and scrutinize borrowers' balance sheet resilience to a long period of elevated debt-servicing liabilities. This will keep the loan-to-value ratio at subdued levels, which will require a greater level of working capital readily available from borrowers. While recent bank failures abroad have had limited impact on the Canadian economy, due to the nation's robust banking system, credit conditions have tightened significantly in the U.S. If this financial stress in the U.S. continues to spread to more banks and nonbank financial institutions, a global recession that is worse than expected could materialize. This may, in turn, lead to a more restrictive financing environment within Canada.

Overnight Rate to Remain Unchanged



Inflation and Interest Rate Trends



** Forecast through December 2023; ** Inflation through March, 10-year government bond yield through April*
Sources: Marcus & Millichap Research Services; Altus Data Solutions; CoStar Group, Inc.; Statistics Canada

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