NATIONAL REPORT

CANADA OFFICE

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

2Q/23

Excess Supply Delays Sector Recovery; Interest Rate Hikes Rekindle Uncertainty for Investors

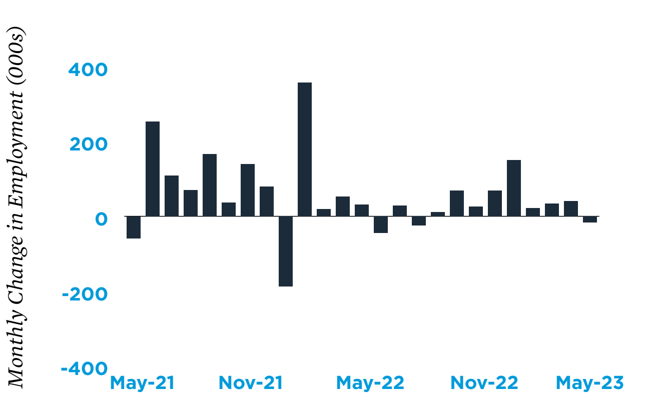
Office sector to face challenges, despite resilient economy. Canada's total employment showed strong momentum over the first five months of 2023, as over 230,000 jobs were created, which maintained the unemployment rate near 5 per cent. This strength in the labour market was accompanied by better-then-expected GDP growth in the first quarter, which reflected an economy that was resilient to elevated interest rates. Despite the strong job gains, fundamentals in the office sector continued on a softening path. On a year-over-year basis, the national vacancy rate rose to 13 per cent in March, with the average asking rent falling below $18 per square foot for the first time since the fourth quarter of 2021. For the remainder of 2023, an anticipated slowdown in economic activity and a surge in supply will likely weaken these metrics further.

Lagging return-to-office a persistent headwind for sector demand. One impact of the global health crisis has been a long-lasting change in regards to in-office work. As remote work arrangements have increasingly become a norm, demand for office spaces is now considerably lower compared to pre-pandemic levels. Between the first quarter of 2020 and the first quarter of 2023, total occupied office stock expanded by only 1.2 per cent. This was significantly lower than the 6.4 per cent growth recorded over the prior three-year period. Unlike other commercial real estate sectors where fundamentals have rebounded along with the post-pandemic economic recovery, the office sector is now confronted with structural forces that may have permanently transformed the demand and supply dynamics.

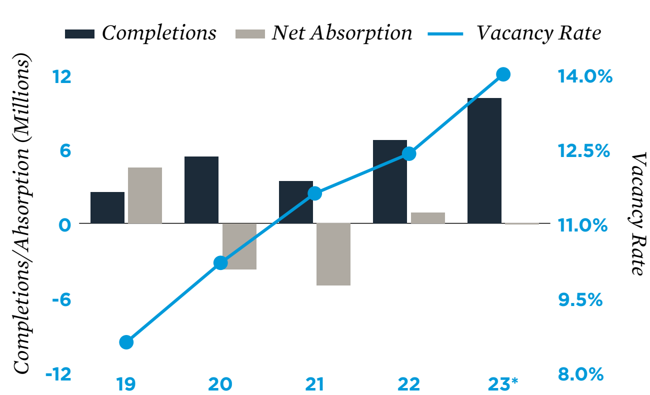
Life sciences sector an emerging demand driver. The lack of a self-sufficient life sciences sector exposed Canada to heightened health-related risks during the pandemic, as the nation could only rely on foreign vaccines. This has prompted many large pharmaceutical companies, such as AstraZeneca and Moderna, to expand their presence in Canada. In addition, entrepreneurship is also on the rise. Vancouver has rolled out a new strategy to help the city become a global life science hub. From 2020 to 2022, over 14,000 jobs were created in the life sciences sector, which was nearly a 100 per cent increase compared to the entire decade before the pandemic. Looking forward, the life sciences sector's expansion will likely be a bright spot in the office sector, despite overall declining demand.

Ongoing office conversion to be countered by surging supply. As an effort to reduce excess supply, the transformation of underutilized office spaces is ongoing across Canada. High-vacancy markets in Alberta have seen the most office conversions in the pipeline so far. In Calgary, 12 downtown office buildings have been approved to turn 1.35 million square feet of empty spaces into residential units. The city government has also revised the program's criteria to allow more redevelopment types, including hotels, schools and performing arts centres. In Edmonton, the government has provided grants to revitalize the downtown area, and roughly 800,000 square feet of under-used office space is being redeveloped. Despite these inventory-downsizing efforts, Toronto, Montreal and Vancouver are expected to see a surge in new supply in 2023. This will continue to put upward pressure on the national vacancy rate over the short-term.

Monthly Change in Employment



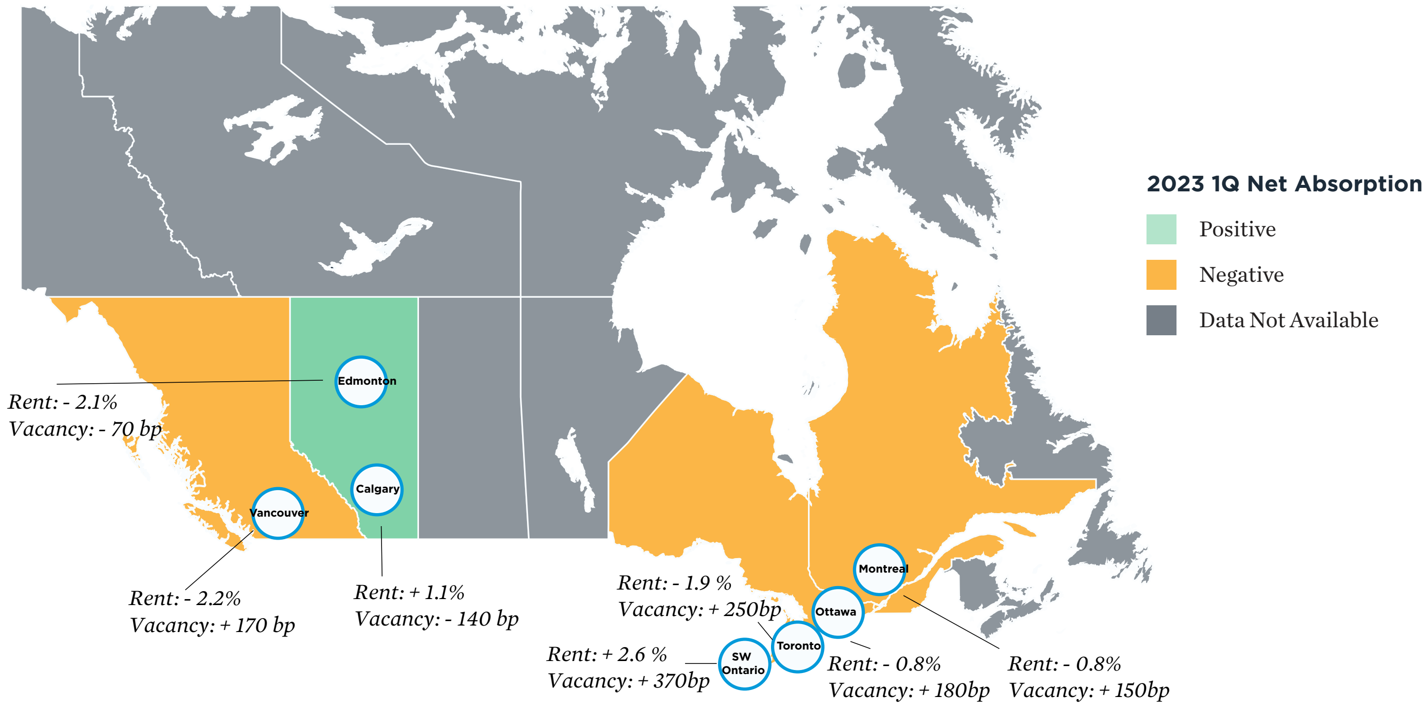
Supply and Demand



* Forecast

Sources: IPA Research Services; Altus Data Solutions; Statistics Canada

2023 Rent Growth and Vacancy Change Forecasts



Sources: IPA Research Services; Altus Data Solutions

WESTERN CANADA

- **Calgary, Alberta:** Calgary has Canada's highest office vacancy rate due to a period of elevated construction and muted absorption preceding the pandemic. Even with elevated oil prices supporting the metro's economy in 2022, Calgary's office sector still suffered from low levels of demand as companies continued to right-size their office footprints. However, vacancy should change trajectory in 2023 and trend down as net absorption turned positive earlier this year while inventory expansion was subdued.

- **Edmonton, Alberta:** The metro saw its office sector fundamentals improve in 2022 with net absorption surpassing pre-pandemic levels. The rebound was most noticeable in suburban markets, as the region is better suited for the evolving hybrid work trend. In 2023, with office-to-residential conversions well underway amid practically no construction, the metro's vacancy rate will likely continue to fall.

- **Vancouver, British Columbia:** Vancouver currently holds Canada's lowest office vacancy as the metro experienced positive net absorption during the past two years. While small- to medium-sized firms will remain active in the leasing market in 2023, driving demand in suburban areas, a notable increase in new supply will outpace demand growth. This will lead to an increase in vacancy, despite relatively healthy demand.

EASTERN CANADA

- **Montreal, Québec:** Montreal has experienced continuously rising vacancy since the onset of the pandemic as companies have reduced their office needs. In 2023, the finalization of the National Bank's new headquarters will cause a further increase in availability, as backfilling the old premises will likely be a challenge.

- **Ottawa, Ontario:** Ottawa's office fundamentals have remained relatively stable, due to the heavy presence of the federal government in the metro. However, the new government remote work arrangement resulting from the PSAC strike in April may slow a near-term recovery in demand.

- **Southwestern Ontario:** The suburban nature in Southwestern Ontario allowed employees to live and work locally, which maintained stable sector fundamentals throughout the pandemic. With subdued pre-leasing activity and tenants consolidating office footprints in 2023, vacancy is expected to rise significantly.

- **Toronto, Ontario:** Elevated interest rates and rapid inflation throughout 2022 weighed on leasing activity, especially in the tech sector. Looking forward, an influx of new supply is expected, with a large share to be completed in the downtown core. This will continue to put upward pressure on the vacancy rate.

2023 Forecast

EMPLOYMENT

1.0% increase Y-O-Y

- Total employment increased 230,000 within the first five months, and the jobless rate remained low. However, the resumption of interest rate hikes will likely weigh on hiring activity later this year.

CONSTRUCTION

10 million square feet completed

- This supply increase will be driven by elevated levels of delivery expected in Toronto, Montreal and Vancouver. Completions are likely to surpass 10 million square feet for the first time since at least 1999.

VACANCY

160 basis point increase Y-O-Y

- On the back of a large increase in completions, national vacancy is anticipated to rise to almost 14 per cent. The wide adoption of hybrid work will likely subdue demand for longer than expected.

ASKING RENT

1.1% decrease Y-O-Y

- The average asking rent is set to drop in 2023. Companies will continue to move to buildings rich in amenities to lure back workers. This flight-to-quality will leave larger stocks of lower-tier assets on the market.

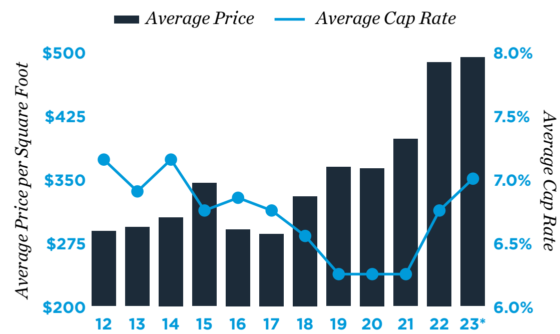
2023 INVESTMENT OUTLOOK

- **Investment activity continued to soften in early 2023.** The trailing 12-month total dollar volume transacted fell nearly 40 per cent in the first quarter of 2023, with the number of deals decreasing 14 per cent. Rising interest rates weighed on financing activity, which impacted investment sentiment. Total dollar volume registered the largest drop in Montreal, followed by Ottawa and Toronto. On the other hand, Calgary saw a surge in investment, due to increasing trades in the $10 million-plus category.

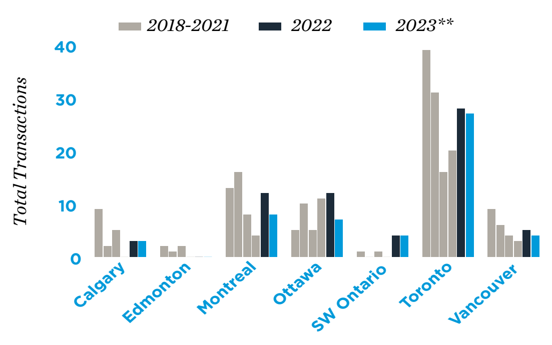
- **Rising interest rates and elevated risks pushed up cap rates.** The average cap rate increased rapidly in 2022, along with the Bank of Canada's rate hikes. Higher risks seen among investors, which are linked to the rising vacancy rate, also contributed to this cap rate increase. The national average sale price jumped 23 per cent, but the gains began to ease in the first quarter of 2023.

- **Weak fundamentals to keep investment activity muted.** As an influx of new supply is expected to push availability to a new high in 2023, many investors will likely continue to wait on the sidelines. The least preferred property types will be Class B and C properties, due to the flight-to-quality trend that is causing subdued demand in these class segments. Office conversions may gain increasing investor attention as fundamentals in these redevelopment projects, which usually involve hotels and purpose-built rentals, are expected to remain positive over the long-term.

Office Investment Sales Trends



Office Transactions Over $20 Million



** Through 1Q; ** trailing 12 months through 1Q*

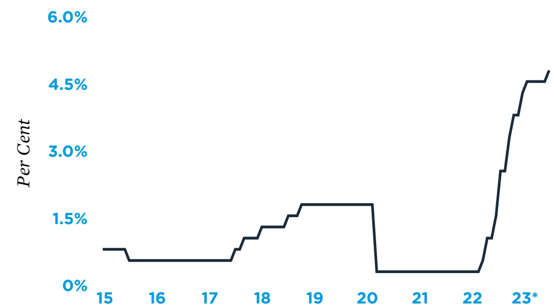
Sources: IPA Research Services; Altus Data Solutions; Statistics Canada

Accelerated Inflation Reactivated Interest Rate Hikes, Weighing on Office Sector Investment

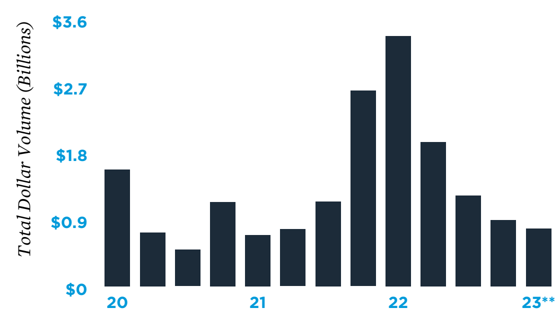
Bank of Canada returns to tightening path. At its June meeting, the Bank of Canada turned hawkish and raised the overnight rate by 25 basis points. Following its decision to hold rates steady in March, Canada's economy continued to surprise on the upside. Between February and April, monthly job gains recorded two consecutive months of increase, maintaining the unemployment rate near a historic low. First quarter GDP growth beat expectations as well, which was led by elevated expansion in private consumption. Housing market activity also picked up in spring as prices began to recover. More importantly, inflation accelerated in April, which showed early signs of more stubborn price growth than previously anticipated. This will likely delay the timing of when inflation will fall to the BoC's 2 per cent target. These developments proved that the monetary environment over the past few months was not tight enough to quell Canada's overheated economy. The BoC's change in policy stance in June indicates that the monetary authority remains resolute in restoring price stability, and now has little tolerance toward any signs of inflation resurgence. While the Bank will still rely on future economic data releases to assess the impact of its cumulative interest rate hikes, the resumption of tightening has opened the door to further restrictive policies over the summer.

Higher interest rates hinder investment recovery. With the BoC coming off the sidelines, financing costs may rise again in the near-term after stabilizing over the past few months. As the possibility of more interest rate hikes increases, uncertainty will start to build once again, likely widening the price expectation gaps between buyers and sellers further. Underwriting standards will tighten to a more restrictive level, with financial institutions putting more importance on borrowers' capacity to withstand elevated financing costs. Investors will likely require higher levels of working capital to demonstrate their balance sheet health. As a result, total investment volume in the commercial real estate sector may remain muted for longer than expected. Additionally, investors will be increasingly selective, which will weigh on trading volume in sectors with less favourable fundamentals. The office sector may therefore be the most impacted market segment as the national average vacancy rate is expected to climb to a new high by the end of 2023, which will also put downward pressure on rents. Nevertheless, Class A properties that are rich in amenities could still fare better, due to a continued flight-to-quality trend leading to positive net absorption and rent growth.

Bank of Canada Overnight Rate



Office Investment Volume



** Through June; ** Through 1Q*
Sources: IPA Research Services; Altus Data Solutions; Bank of Canada

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