NATIONAL REPORT

Canada Retail

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

2Q/23

Sector Fundamentals Gain Support from Resilient Economy, Ongoing Product Diversification Drives Long-Term Returns

Economic resilience continues across the nation. Canada's economy got off to a good start in 2023. Job creation within the first three months exceeded expectations, with the unemployment rate hovering near a historic low. Consumer spending also remained healthy as retail sales continued to expand at a steady pace. While economic activity across the nation will likely soften in the upcoming months, due to still-high inflation and a prolonged period of elevated interest rates, robust economic data released so far this year suggests that the Canadian economy may only witness a mild slowdown without having to experience a significant rise in unemployment. This positive macroeconomic backdrop, if realized, will bode well for Canada's retail sector. In addition, the pandemic has changed and diversified the role of physical stores, which will further increase demand for retail space over the coming years.

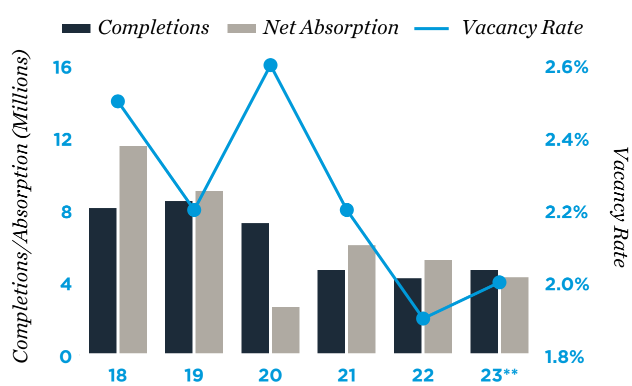
Softening labour market to cool demand. Given the macroeconomic backdrop, Canada's total employment will likely remain relatively stable in 2023, and the jobless rate should end the year around 6 per cent. This softening in employment growth, however, will be much milder compared to the previous slump seen in 2020. Consumer spending will moderate as a result, but should remain at a healthy level, given an expanding consumer base aided by a continued increase in international migration. Consequently, net absorption will record a slight decline this year, which will exert mild upward pressure on the national vacancy rate over the short-term.

Evolving role of physical stores to drive future demand. The health crisis has changed consumer behaviour and is now transforming the retail landscape across Canada. In the early stage of the pandemic, e-commerce sales skyrocketed as consumers stayed home in order to contain the spread of the virus. As soon as health restrictions began to loosen, however, brick and mortar stores saw a swift return of foot traffic. Today, consumers are demanding not only physical goods, but also a variety of shopping experiences. In response to this, omni-channel retail is on the rise, with an increasing number of operators diversifying in-store services, such as BOPIS (buy online pick up in store) and home/office deliveries. These additional services will increasingly become a structural force over the upcoming years to drive demand in the retail sector, which is likely to be reflected as an increase in square footage required per store.

Lackluster inventory expansion to support sector fundamentals. In 2023, elevated interest rates and high construction costs will continue to weigh on development activity. Most metros will see completions soften or remain stable compared to the prior year, which will help prevent vacancy from rising significantly on the back of moderating demand. Toronto, however, will stand out as one of the few markets where a large inventory expansion is anticipated, due to the expected completion of The Well retail podium. Nevertheless, with most spaces having been pre-leased, there will likely be limited upside movement in the vacancy rate.

Inflation-Adjusted Retail Sales

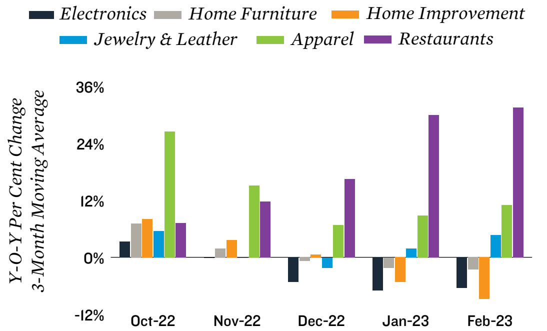
Supply and Demand



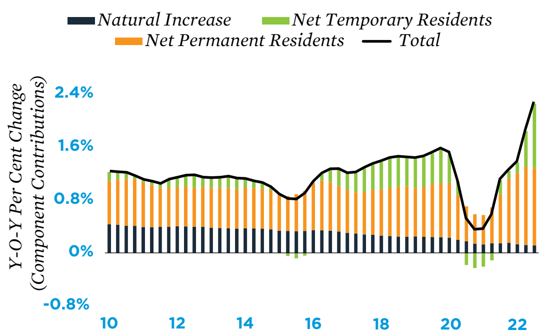
* Through January. ** Forecast

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

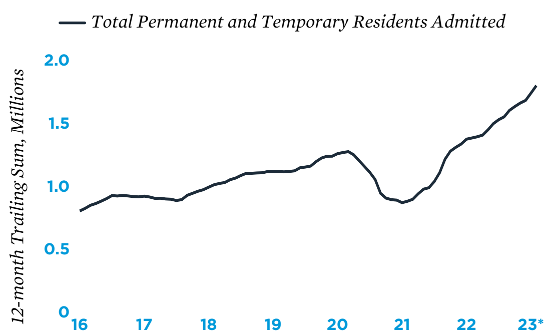
Select Discretionary Spending Trend



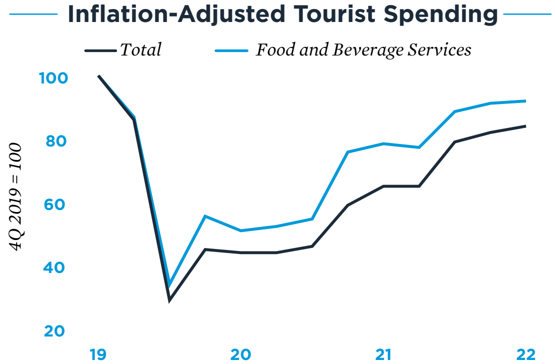
Canada Population



International Migration into Canada



Inflation-Adjusted Tourist Spending



** Through January*

Sources: IPA Research Services; Immigration; Refugees and Citizenship Canada; Mastercard; RBC; Statistics Canada

Product Diversification Well Underway, Adjusting to New Spending Habits in the Post-Pandemic Future

Consumers are entering a new normal. As the Bank of Canada is expected to hold its overnight rate steady throughout 2023, consumers will be faced with elevated interest rates for an extended period of time. This will tighten household budgets, especially for discretionary spending. Within the discretionary category, however, current consumer preference varies greatly across different segments. The removal of health restrictions has enabled engagement in more entertainment-based activities and shifted spending from home improvement to other leisure items. Spending data from Mastercard and RBC indicates that travel, restaurants, apparel and jewelry expenditures continue to grow at a robust pace. Meanwhile, demand for home furniture & furnishings and electronics is moderating. This growing appetite for experiential goods and services has led to an increase in retail offerings.

Retailers and developers are adapting to new consumer preference. Various types of diversification projects are currently underway across Canada to meet this changing demand. The redevelopment of The Post in Vancouver, for instance, will feature a food hall, which offers both casual and upscale dining experiences, as well as a fitness and health centre that provides rock climbing, chiropractic services and a spa facility. Additionally, larger-scale projects — including The Well in Toronto and Royalmount in Montreal — may set the bar for the next generation of destination retail that combines shopping with a wide variety of social and entertainment activities. Over the coming years, Canada is likely to see an increase in these multi-functional retail developments as consumers expect more from their shopping experiences.

Retailers to Benefit from Expanding Consumer Base

Rising immigration strengthens Canada's consumer base. As international migration reached a historic high, Canada's population growth now relies almost solely on immigration. After travel restrictions were removed in 2022, Canada accelerated the pace of migrant intake in order to make up the loss incurred during the pandemic. By the end of 2025, the nation plans to welcome another 1.45 million new immigrants and increase the admission of international students and foreign workers. This will continue to solidify Canada's consumer base. Suburban retailers, in particular, will likely benefit more from this demographic development, as an increasing share of these new settlers now opt to reside away from city centres.

Further recovery in tourism bodes well for the retail sector. A strong recovery in tourism was seen in 2022. Cities like Vancouver, Calgary and Montreal, which are prime destinations, welcomed a record number of tourists since the pandemic. In 2023, which will be the first year free of travel restrictions, the industry should continue to witness pent-up tourism demand play out across Canada. This will lead to an increase in foot traffic for the retail sector. Additionally, visitors from the U.S. — the top source country for tourists to Canada — will likely increase their spending due to a weak Canadian dollar, relative to the U.S. dollar, throughout 2023.

Sales Volume to Make a Comeback Amid Positive Long-Term Outlook

2023 Forecast

CANADA EMPLOYMENT

1.0% increase Y-O-Y

- Employment will likely grow in 2023, although only marginally. Elevated interest rates will weigh on Canada's economic performance, as business investment and consumer spending are expected to soften.

CANADA CONSTRUCTION

4.7 million square feet to be completed

- The pace of delivery will remain relatively stable in 2023. Several large projects delayed during the pandemic are expected for delivery this year, causing a slight uptick in completions.

CANADA VACANCY

10 basis point increase Y-O-Y

- Ongoing economic headwinds will moderate leasing activity, putting upward pressure on vacancy. Increasing immigration, however, will solidify Canada's consumer base and help prevent a large spike.

CANADA ASKING RENT

1.5% increase Y-O-Y

- As the vacancy rate is expected to remain tight at approximately 2 per cent, the average asking rent will continue to rise, albeit at a slower pace due to a slight moderation in demand.

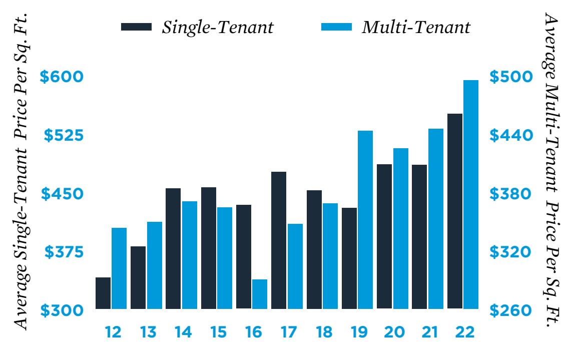
2023 INVESTMENT OUTLOOK

- **Sales activity softened, single-tenant transactions held up well.** Rapidly rising interest rates have not only increased financing costs, but also widened price expectation gaps between buyers and sellers. This caused sales activity to slow significantly during the second half of 2022, which led to a 9 per cent decrease in total dollar volume for the full year. Multi-tenant transactions registered the largest decline, while investment in the single-tenant sector held steady. This was likely due to favourable lease terms and more established tenants often associated with the single-tenant sector.

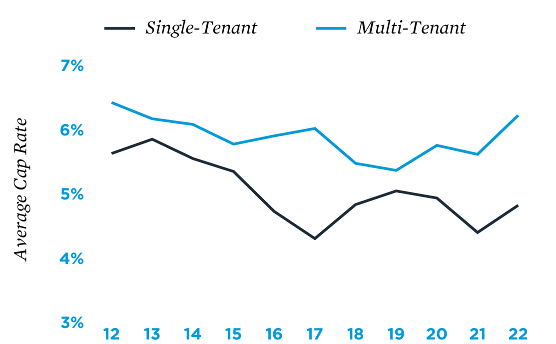
- **Price growth accelerated in most metros**. The national average sale price reached a new high in 2022, with most metros recording an acceleration in sale price growth. Vancouver saw the largest price increase of 29 per cent, followed by a 19 per cent advancement seen in Southwestern Ontario. The average cap rate rose roughly 50 basis points across all property types on the back of rising interest rates. Non-anchored strip centres continued to offer the highest yield, between 6.5 and 7.0 per cent.

- **Stabilizing financing conditions to improve investor sentiment.** As the Bank of Canada is expected to hold its overnight rate unchanged for the remainder of 2023, financing conditions should stabilize, with price expectations between buyers and sellers gradually reaching a new equilibrium. This will help buyers that stayed idle re-enter the market this year, as the long-term outlook for Canada's retail sector remains positive.

Canada Retail Sale Price Trends



Canada Retail Cap Rate Trends



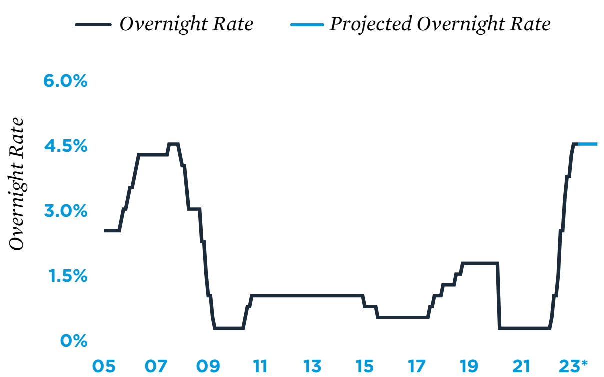
Sources: IPA Research Services; Altus Data Solutions; CoStar Group, Inc.; Statistics Canada

Inflation Continues to Slow Amid Upside Risks; Investment Activity to Recover on Stabilizing Interest Rates

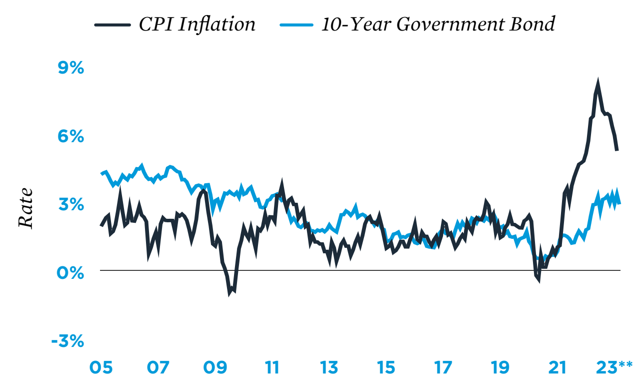
Interest rates to remain unchanged, while short-term inflationary pressure mounts. As inflation has slowed for eight straight months, reaching 5.2 per cent in February, the BoC has adopted a wait-and-see approach to assess the impact of its cumulative interest rate hikes. Although price growth is still above the bank's inflation target, it is projected that the headline rate will approach 2 per cent by the end of 2023. However, inflationary risks still remain as the labour market continues to register robust gains, with the unemployment rate remaining near a historic low. This will put upward pressure on wage growth and, in turn, overall inflation for the coming months. Additionally, the U.S. and Europe continue to see robust economic performance, which, coupled with the recent cut in oil production announced by OPEC+, could rekindle a surge in international oil prices over the near-term. These domestic and international developments may potentially revert the declining trend of inflation in Canada, increasing the likelihood of further interest rate hikes by the BoC. Nonetheless, additional broad-based indicators continue to suggest inflation will trend down.

Stabilizing financing conditions, incoming large projects and positive long-term outlook set the stage for a rebound in investment. With a conditional pause on interest rate hikes, financing costs will remain elevated for investors, but the current monetary environment provides a greater certainty for the future interest rate path. This should allow market participants to quickly adjust to the new normal and diminish expectation gaps between buyers and sellers. During the second half of 2022, many investors opted to stay on the sidelines, causing a notable decrease in total dollar volume traded in the retail sector. In and beyond 2023, investment capital should return as investors eye several large projects — including The Well in Toronto, Royalmount in Montreal and a new NHL arena in Ottawa — for future opportunities. Additionally, recent bank failures in the U.S. and Europe will likely have a limited impact on Canada, as the Canadian banking sector remains healthy and resilient. This should protect investors against a meaningful tightening in lending requirements. Given a positive demographic development in Canada underpinning retail sector fundamentals, investors will treat this year as an opportunity to position themselves for positive long-term returns.

Overnight Rate to Remain Unchanged



Inflation and Interest Rate Trends



** Forecast through December 2023; **Inflation rate through February, 10-year government bond yield through March*
Sources: IPA Research Services; Bank of Canada, Statistics Canada; TD Bank

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