NATIONAL REPORT

CANADA MULTIFAMILY

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

3Q/23

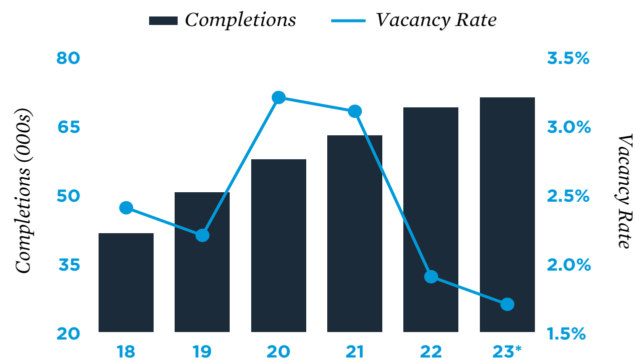
Apartment Demand Keeps Climbing Amid Strong Demographic Tailwinds and Soaring Home Prices

Demand forces remain in driver's seat. While Canada saw a record number of new apartments added to the rental market in 2022, the sector's vacancy rate tightened to the lowest level since 2001. This indicates that rental demand significantly outgrew supply as the nation's economy continued its recovery from the global health crisis. With an increasing number of new residents and rapidly rising interest rates, population growth and deteriorating affordability in the homeownership market were the main drivers for this ballooning rental demand. Although a further increase in completions is expected this year, these demand tailwinds will still dominate the market. The national average vacancy rate, as a result, will likely continue to trend down, sending rents to a post-pandemic high.

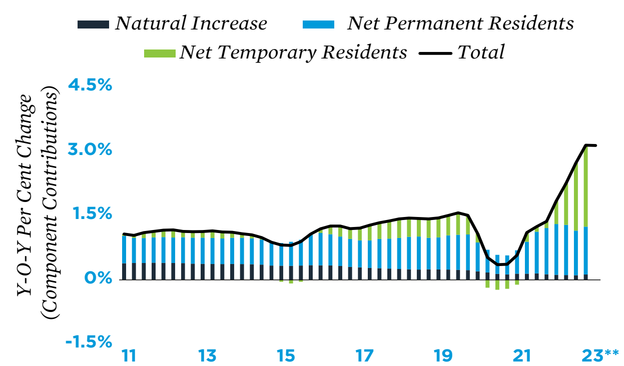
Population growth now at a multi-decade high. Led by a swift return of new settlers upon the removal of travel restrictions, Canada's total population expanded 3.1 per cent year-over-year as of the second quarter of 2023. As the birth rate remained low, over 95 per cent of this population gain was from inflows of permanent residents, foreign workers and international students. This means that nearly all these new residents required additional housing, with rental apartments being their first choice. Driven by this demographic trend, new supply has been absorbed at a fast pace as soon as leasing commences, continuing downward pressure on the national vacancy rate. With an aim to welcome 1.45 million immigrants by 2025, vacancy rates across Canada are expected to remain at low levels over the coming years.

Homeownership challenges pushing up rents. Elevated home prices and rapidly rising interest rates have deteriorated Canada's housing affordability. According to the Bank of Canada's housing affordability index, an average Canadian household now allocates approximately 50 per cent of disposable income toward mortgage payments and utility fees — the highest level seen since the early 1990s. These elevated ownership costs have sidelined many potential home buyers and shifted a large portion of housing demand to the rental market, putting upward pressure on rents. With the BoC raising interest rates to a new high in July, homeownership costs will likely remain elevated for the remainder of 2023, which will continue to redirect demand toward the multifamily sector. Rental rate growth, which has outrun the headline inflation rate since late 2022, is expected to remain elevated. On the national level, the average effective rent is anticipated to increase 7.1 per cent annually and approach $1,300 per month by year-end.

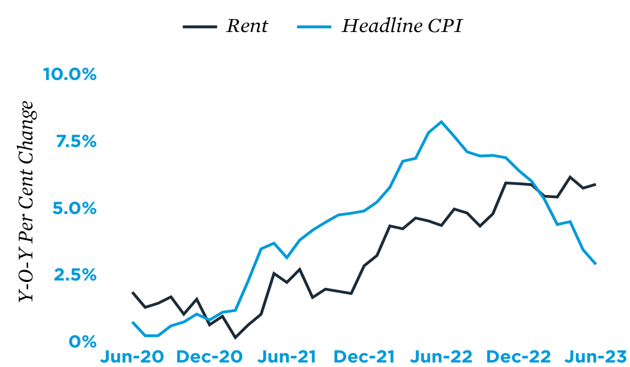
Supply and Demand



Canada Population

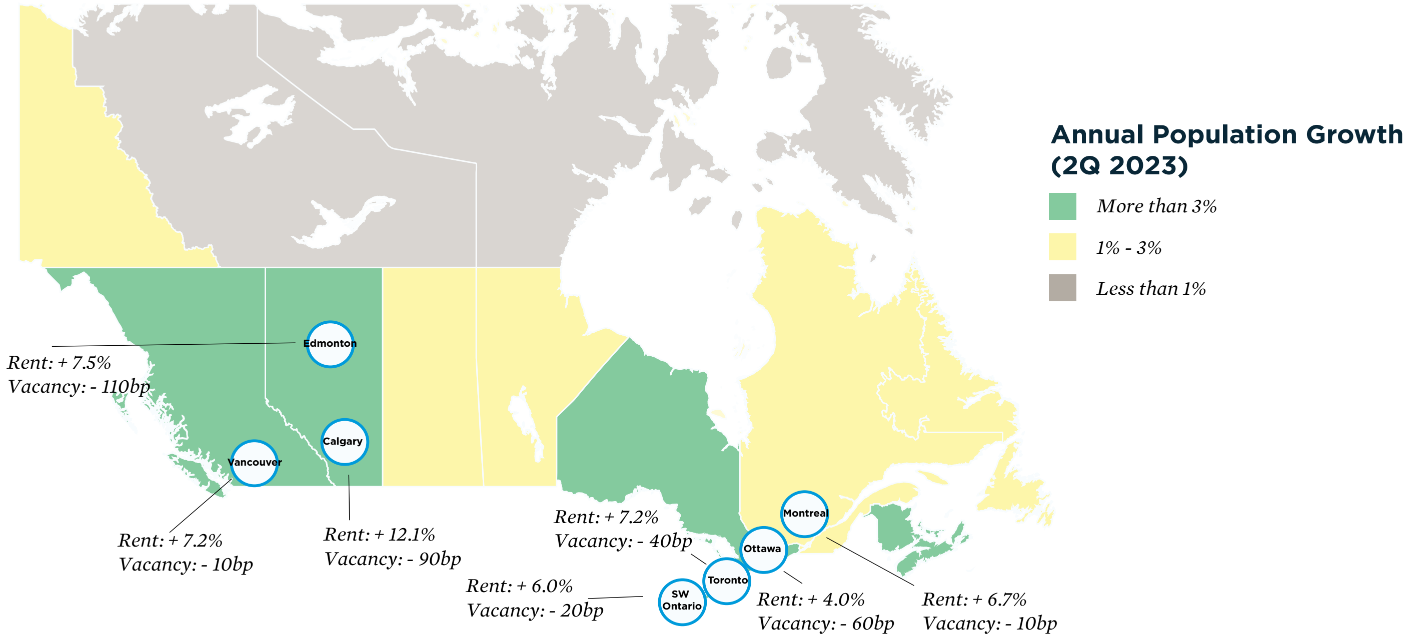


Rent Increase Outpacing Overall Inflation



* Forecast; ** Total growth rate through 2Q, Component contribution through 1Q
Sources: IPA Research Services; CMHC; Statistics Canada

2023 Rent Growth and Vacancy Change Forecasts



Sources: IPA Research Services; Canada Mortgage and Housing Corporation, Statistics Canada

WESTERN CANADA

- **Calgary, Alberta:** Alberta saw one of the strongest population expansions in Canada during the first half of 2023, welcoming over 100,000 new residents. This provided the backbone for the metro's increasing rental demand. Calgary's average home price has eclipsed the previous peak seen in February 2022, which will continue to re-direct housing demand to the rental market. These demand forces will likely lead to a double-digit percentage rent increase in 2023.

- **Edmonton, Alberta:** Edmonton has welcomed an influx of new residents since the start of the pandemic, due to its relatively low cost of living. This demand has put consistent upward pressure on rents. While annual completions are forecast to surpass 4,000 units in 2023, demand will likely continue to outpace supply, compressing the metro's vacancy rate close to 3.0 per cent.

- **Vancouver, British Columbia:** Vancouver has long been Canada's tightest rental market, with vacancy dropping below 1 per cent in 2022. While city planners and developers have managed to increase new supply, absorption has outpaced completions. Furthermore, projects are now taking longer to be delivered due to elevated construction costs, rising interest rates and labour shortages. These factors will likely maintain the metro's apartment vacancy rate at an extremely low level.

EASTERN CANADA

- **Montreal, Québec:** In Montreal, a healthy job market and a large gain in new residents will continue to put downward pressure on apartment vacancy rates. The strong presence of the tech, healthcare and aerospace sectors, coupled with the metro's highly educated population, bodes well for Class A apartment demand.

- **Ottawa, Ontario:** Ottawa's job market has a relatively high level of stability as it benefits from a large share of federal government employees. This supports demand in the multifamily sector in case of an economic recession. The return of the student population will also continue to support multifamily fundamentals.

- **Southwestern Ontario:** As the remote work trend fades, resident gains from immigration will take the lead as the main supporter for the metro's growing apartment demand. Employment in the rising electric vehicle sector will also aid long-term rental demand.

- **Toronto, Ontario:** Toronto remains the top destination for new immigrants, and will continue to see unmitigated apartment demand as Canada is set to welcome a record number of newcomers by 2025. Still, changing tenant preferences toward larger living areas and access to outdoor space has impacted demand in studio and one-bedroom apartments in the city centre.

2023 Forecast

EMPLOYMENT

1.8% increase Y-O-Y

- Total employment increased by 290,000 in the first half of the year, boosted by an elevated level of immigration. Employment growth, however, may slow over the second half of the year as the economy fully absorbs higher borrowing costs.

CONSTRUCTION

71,000 units completed

- Construction activity will continue on an upward trajectory as builders attempt to increase supply to meet demand from Canada's growing population. Toronto and Vancouver will see a notable increase in deliveries.

VACANCY

40 basis point decrease Y-O-Y

- Vacancy will fall to 1.7 per cent as demand is expected to outgrow supply. Most major metros will see a sub-2 per cent vacancy rate, indicating significantly tight market conditions nationwide.

ASKING RENT

7.1% increase Y-O-Y

- The average effective rent is expected to approach $1,300 per month, driven by tightening vacancy rates across Canada. Alberta, Toronto and Vancouver will likely see some of the highest rent increases in 2023.

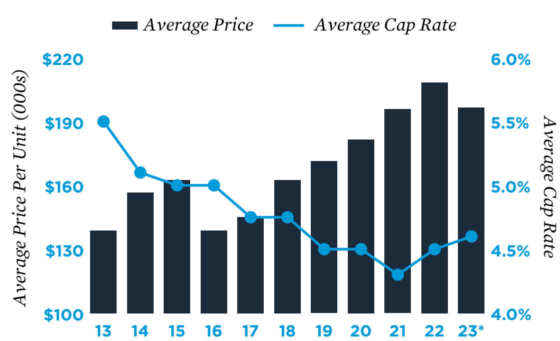
2023 INVESTMENT OUTLOOK

- **Investment activity remained soft.** Partly due to rising interest rates, the trailing 12-month total dollar volume transacted dropped 50 per cent annually in the second quarter of 2023. From April to June, eastern metros saw stronger sales activity compared to western regions, with Toronto, Southwestern Ontario and Montreal registering improving quarter-over-quarter momentum in the total dollar volume transacted.

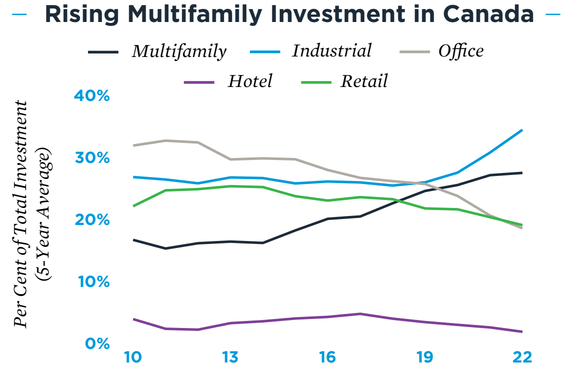
- **Cap rates rising on softening prices.** The national average sale price per unit slightly ticked down, falling below the $200,000 mark in the second quarter of 2023. Rising financing costs impacted investor enthusiasm, leading to a softening in sale prices across Canada. Cap rates increased in most metros, due to sound sector fundamentals and the decline in sale prices. The national average rate ended the second quarter 10 basis points higher compared to last year, hovering around 4.6 per cent.

- **Investors increasingly favouring multifamily sector.** Following the 2015-2016 oil shock, investment in the multifamily sector began to recover, which was hardly interrupted by the pandemic. Total dollar volume in apartments reached close to 30 per cent of all CRE investment in Canada at the end of 2022, up from just 16 per cent a decade ago. Moving forward, a record level of population growth from immigration and reduced housing affordability will likely maintain elevated demand for apartments, which will continue to bode well for investor sentiment.

Multifamily Investment Sales Trends



Rising Multifamily Investment in Canada



** Through 2Q*

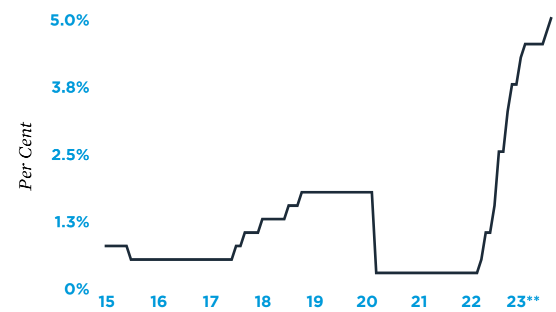
Sources: IPA Research Services; Altus Data Solutions

Monetary Environment Tightens Further, Weighing on Near-Term CRE Investment Momentum

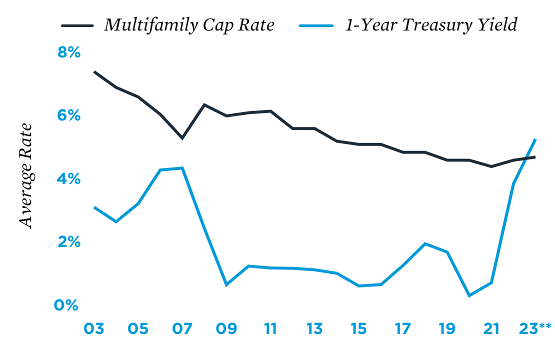
Bank of Canada strikes hawkish tone as economy continues to outperform. As widely expected, the BoC hiked its overnight rate for the third time this year in July. In its press release, while the monetary authority acknowledged that domestic and global inflation was easing on the heels of softening energy and goods price inflation, it stressed that the domestic economy performed better than expected with "surprisingly strong" consumption in the first quarter. Furthermore, the housing market showed early signs of resurgence; together with lagging construction, home prices rose again this spring. The labour market also remained tight despite a record level of immigration, which kept wage growth at elevated levels. More importantly, underlying inflationary pressure, measured by three-month rates of core inflation, still hovered well above the inflation target. All these developments led to a hawkish message from the BoC, which stated that the bank "remains concerned that progress towards the 2 percent target could stall, jeopardizing the return to price stability." Although the majority of market participants don't expect further rate hikes for the remainder of 2023, the Bank will remain data-dependent and can bring rates to higher ground if deemed necessary in order to restore price stability.

Multifamily sector benefits long-term investors. Rekindled interest rate hikes and the possibility of further tightening have led to a fresh round of increasing financing costs and climbing uncertainty for investors. Lenders will now need to see more robust debt-servicing capabilities from borrowers, which will likely cause the availability of credit to shrink. The incremental improvement in investment volume, which was seen earlier this year when the BoC paused interest rate hikes, may prove to be short-lived. Furthermore, treasury bill yields have notably moved up, with interest rates on most short-term government securities currently standing above 5.0 per cent. These lower-risk options could further shift some demand from commercial real estate to the fixed income market in the near-term as treasury bill yields have risen above cap rates on many commercial real estate assets. In the second half of 2023, investor sentiment could remain subdued, especially if future developments warrant a tighter monetary environment. Given elevated population growth and multi-year-low vacancy rates across Canada, multifamily properties should stand out as one of the lower-risk CRE assets with healthy fundamentals and a more predictable outlook. This should continue to attract long-term investors despite short-term ups and downs in the credit market.

Bank of Canada Overnight Rate



Treasury Bill Yield Now Above Cap Rate



** Through July; ** Cap rate through 2Q, 1-year treasury bill yield as of July 26*
Sources: IPA Research Services; Altus Data Solutions; Bank of Canada

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