NATIONAL REPORT

Canada Retail

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

3Q/23

Positive Economic Outlook Benefits Retail Sector; Downtown Properties Face Elevated Vacancy

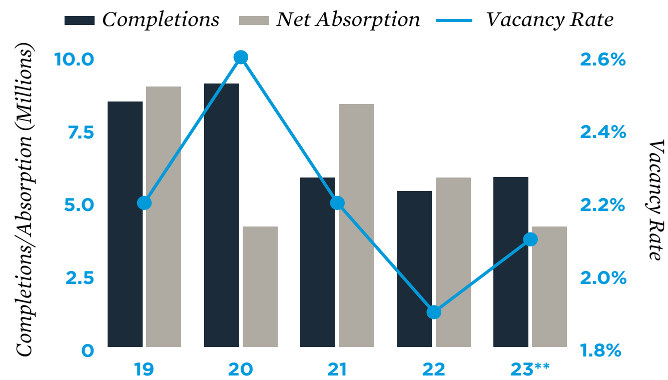
Canada's economy has outperformed expectations. In the first half of 2023, the Canadian economy weathered rising interest rates better than expected. The labour market remained in expansion mode, adding roughly 290,000 jobs during the first six months. This strong job creation provided support for consumer spending. Within the first five months, Canadians spent 2.9 per cent more on retail goods and 20 per cent more on restaurant dining compared to a year ago. With robust job growth and consumer spending pointing toward a stronger-than-anticipated economy so far this year, a soft landing against rising interest rates has become more likely. In this scenario, economic growth would slow moderately without a significant rise in unemployment, which should keep the retail sector well positioned.

Increase in supply to push up vacancy rates. The robust economic performance has been well reflected in leasing activity. In the first half of the year, net absorption outpaced deliveries, causing the national average vacancy rate to decrease to the lowest level on record. All major markets, excluding Montreal and Edmonton, saw a year-over-year drop, and almost all metros outside Alberta experienced below-2 per cent vacancy. Amid declining available space, the average asking rent continued to advance after rising above $29 per square foot at the end of 2022. On the supply side, construction activity in most metros is being impacted by elevated financing and construction costs. Nationally, completions are expected to eclipse last year's level due to a significant increase in deliveries expected in Toronto. This will likely lead to a slight uptick in the national vacancy rate.

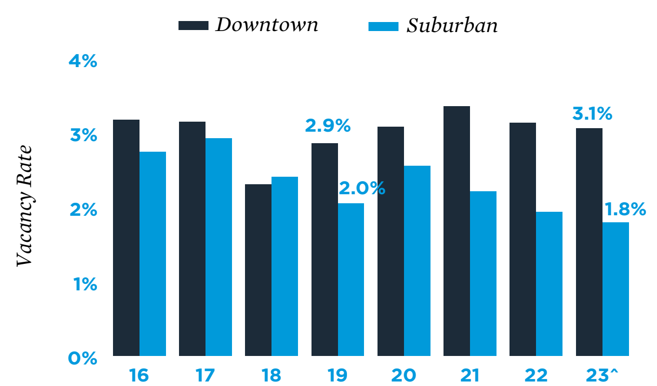
Challenges continue for downtown operators. As hybrid work has become the norm for many office jobs, the return to the workplace appears to have slowed. After the initial rebound, foot traffic in Canada's downtown areas now remains below the pre-pandemic level. As the Bank of Canada has brought the overnight rate to a new high, some retailers have halted their expansion in downtown areas, leading to negative net absorption in many metros in the second quarter of 2023. Consequently, the national average downtown vacancy rate continued to hover at elevated levels above 3.0 per cent. In contrast, vacancy outside urban centres continued to recede amid robust consumer demand for suburban essential retail. As of the second quarter, the average vacancy rate outside downtown regions fell to 1.8 per cent, the lowest since 2016.

Inflation-Adjusted Retail Sales

Supply and Demand

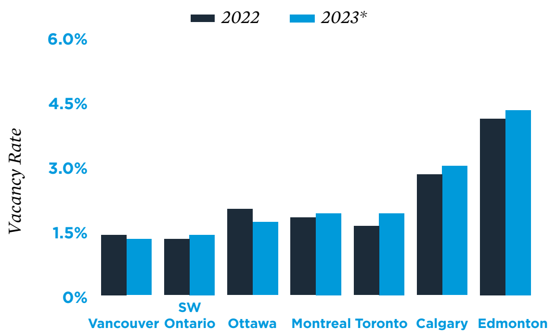


Elevated Vacancy in Urban Centres

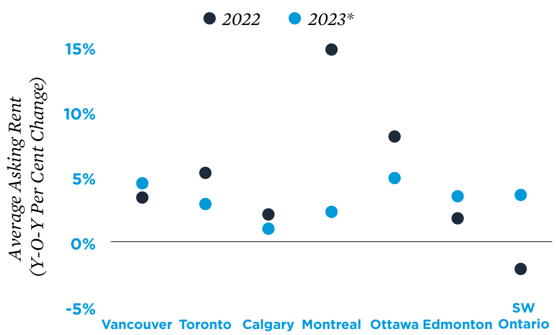


** Through May; ** Forecast; ^ As of 2Q*
The downtown and suburban vacancy rates are calculated using data for Calgary, Edmonton, Ottawa, Toronto and Vancouver.
Sources: IPA Research Services; CoStar Group, Inc.; Statistics Canada

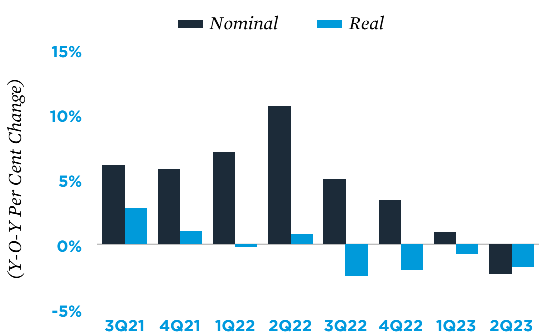
Retail Vacancy to Increase Slightly



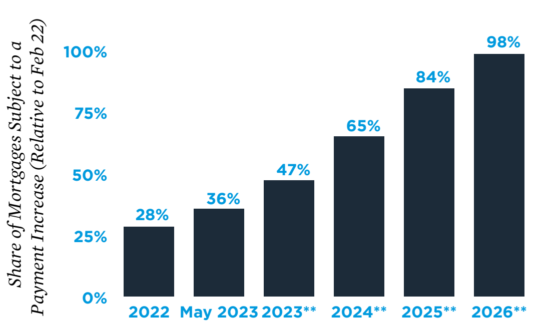
Rents Remain on Upward Trajectory



Retail Sales Per Capita Already Declining



Rising Debt Burden for More Borrowers



** Forecast; ** Projections from the Bank of Canada*
Sources: IPA Research Services; Bank of Canada; CoStar Group Inc.; Statistics Canada

Major Market Overviews

Western Canada. This region of Canada saw some of the greatest gains in consumer spending year-to-date. In the first half of the year, total retail sales in Alberta grew 6.8 per cent year-over-year, the second-highest pace nationwide. Spending at restaurants and bars during this period in the province also grew at a robust rate of 17 per cent. In Vancouver, the vacancy rate reached the lowest level on record in the second quarter of 2023 due to strong leasing activity. For the remainder of the year, a continued influx of new residents and a boom in the tourism sector will solidify the metro's consumer base and maintain healthy retail sector fundamentals.

Eastern Canada. In Toronto, the vacancy rate is expected to increase 30 basis points on the heels of a significant increase in completions. After several years of construction, The Well retail podium will be delivered, diversifying the shopping experience in the downtown area. In Montreal, leasing demand showed early signs of softening in the second quarter, but limited new supply is expected to help maintain the metro's vacancy rate at a low level. A growing student population and the suburban nature in Southwestern Ontario have benefited retailers and will bode well for the sector's long-term outlook. In Ottawa, the vacancy rate is estimated to shrink amid subdued construction activity and healthy demand as the large public sector presence supports stable retail sales in times of uncertainty.

Pockets of Softness Constitute Downside Risks

Retail sales per capita already on the descent. While Canada's economy continues to create jobs, its labour market is showing early signs of moderation. With a high level of immigration, the labour force is now expanding at a faster pace than the employed population. This has led to a 50-basis-point increase in the unemployment rate from April to July. Additionally, resident gains and rising prices are now the main contributors to retail sales growth. Adjusted for population and inflation, real retail sales per capita has already contracted for four consecutive quarters since mid-2022. Over the upcoming months, with inflation having come off the peak, Canada's growing population may not be sufficient to maintain total retail sales in expansion mode if unemployment rises significantly, causing a notable contraction in consumer budgets.

Rising debt burden could induce further reduction in consumption. As of May 2023, a little over one-third of mortgages in Canada saw an increase in payments compared to February 2022, which was just before the Bank of Canada launched its current tightening cycle. This shows that the majority of homeowners in Canada have not been faced with increasing interest costs. However, as more households renew their mortgages, it is estimated that a payment increase will apply to nearly 50 per cent of these home loans by the end of this year. This number is anticipated to rise further to 65 per cent by the end of 2024. Coupled with an expected increase in the jobless rate and a decline in household savings, there may be more headwinds in the next couple of quarters weighing on consumer spending. Moreover, if the BoC continues to raise interest rates, household debt will likely balloon to a new high, putting more downward pressure on demand in the retail sector.

2023 Forecast: Retail Fundamentals Expected to Remain Healthy

EMPLOYMENT

1.8% increase Y-O-Y

- In the first half of 2023, Canada's labour market remained healthy, adding 290,000 jobs. This momentum, however, is expected to slow in the coming months as elevated interest rates weigh on hiring activity.

CONSTRUCTION

5.9 million square feet to be completed

- On the national level, the pace of delivery will accelerate in 2023. This increase will be most noticeable in Toronto, where several large projects are slated to open later this year.

VACANCY

20 basis point increase Y-O-Y

- The national vacancy rate declined in the first half, but is expected to end the year slightly higher. This is a result of an increase in completions and moderating consumer spending toward the second half of 2023.

ASKING RENT

3.1% increase Y-O-Y

- The average asking rent will remain on an upward trajectory in all major markets. Vancouver and Ottawa are expected to see the highest rates of rent increase as supply growth slows notably.

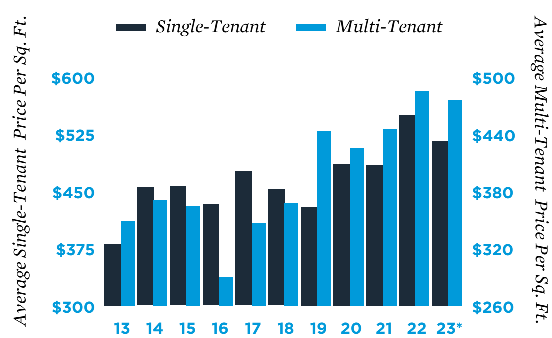
2023 Investment Outlook

- **Sales activity hampered by rising interest rates.** As the BoC resumed interest hikes in June, investment activity was further subdued in the second quarter, with total dollar volume transacted falling below $1 billion. On the trailing 12-month basis, single-tenant transactions held up slightly better than multi-tenant transactions, driven by relatively stronger sales volume in the first quarter. Metro-wise, this softening in trading activity was most visible in Toronto, Vancouver, Southwestern Ontario and Ottawa.

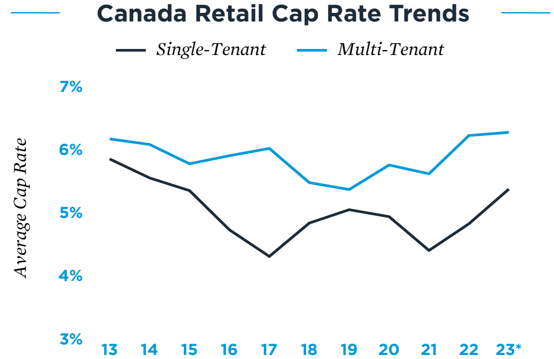
- **Pullback on investment pushing down sale price**. The average sale price ticked down 4.0 per cent year-over-year in the second quarter of 2023, likely driven by a slowdown in investment activity as higher borrowing costs weighed on investor sentiment. Due to rising interest rates and this mild drop in sale prices, the national cap rate continued to trend up. The cap rate gap between multi- and single-tenant assets remained wide, indicating a continued preference for single-tenant properties in the current macro environment.

- **Short-term challenges to impact investor sentiment.** Elevated financing costs, an expected softening in consumer spending, and downside risks for the sector will likely keep investment activity muted in the second half of 2023. Investors will remain cautious and closely monitor macroeconomic developments in the next few months. Potential buyers will likely become increasingly selective, focusing on properties that can better weather near-term headwinds.

Canada Retail Sale Price Trends



Canada Retail Cap Rate Trends



** Trailing 12 months through 2Q*

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

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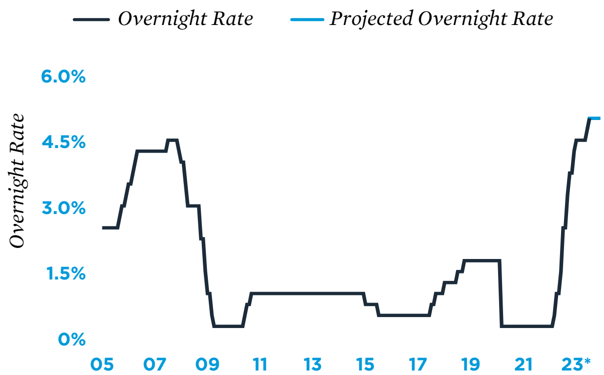
Investment to Bear the Brunt of Elevated Interest Rates

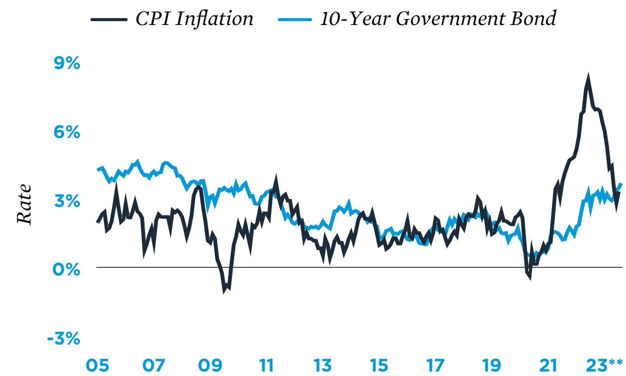
Further softening in economic activity may put a stop to rate hikes in the near term. Following the BoC's July rate hike announcement, the Bank disclosed more information that led to this policy decision. The monetary authority evaluated two scenarios related to the inflation outlook, which included both over- and under-tightening. The final conclusion of a 25-basis-point rate increase indicated that the monetary environment needed to be more restrictive to quell excess demand in the economy and keep inflation expectations well anchored. Since the last rate hike, data releases have come in a mixed bag. July's headline inflation was higher than expected, while core measures eased. Total employment dropped unexpectedly in July, but wage growth accelerated. Nominal retail sales registered the first year-over-year decline in June since the pandemic, showing further signs of moderating consumer spending. As elevated interest rates work their way through the economy, more softening in overall economic activity is expected in the second half of 2023, which should prevent further rate hikes for the remainder of this year. However, the BoC will remain data-dependent and raise rates again if inflationary pressures prove to be stickier than projected.

Potential buyers to become more selective in retail investment. Since the BoC's July rate hike, interest rates have remained on an upward trajectory across the board. Yields on government debt continued to climb, and interest rates for households and businesses also rose to a new high. This will make financing more difficult and weigh on investment activity in the short term. Lenders will require greater balance sheet resilience against a longer period of elevated interest rates. Coupled with uncertainties around near-term economic performance, the availability of capital for retail investment is expected to remain low compared to last year's level. Investors will likely seek assets that prove to be resilient during an economic recession, such as single-tenant and essential retail properties in densely-populated suburban areas. Data on total dollar volume transacted in the first half of 2023 also suggests that investors may prefer markets with higher population growth, including Calgary and Edmonton, as a fast-growing consumer base provides a cushion for total retail demand during economic downturns.

BoC to Keep Overnight Rate Unchanged



Inflation and Interest Rate Trends



** Forecast through December 2023; **Inflation rate through July, 10-year government bond yield through August 23*

Sources: IPA Research Services; Bank of Canada, RBC; TD Bank

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