NATIONAL REPORT

CANADA INDUSTRIAL

IPA INSTITUTIONAL PROPERTY ADVISORS

A DIVISION OF MARCUS & MILLICHAP, BROKERAGE

4Q/23

Booming Sector Output Aids Fundamentals; Rising Vacancy Offers More Space Options

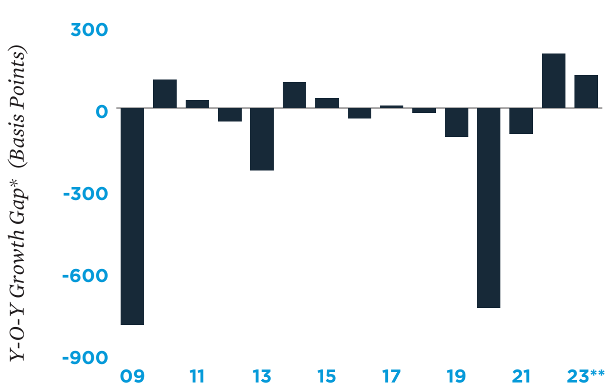
Industrial-intensive sectors continue to outperform. For years up until 2022, Canada's industrial space-using sectors had either underperformed or grown at a similar rate compared to the overall economy. The global health crisis, however, seems to have bucked this trend with surging demand for e-commerce in the early stages of the pandemic, which was later followed by supply chain nearshoring due to escalating global geopolitical tensions. Year-over-year output growth in the industrial space-using sectors, as a result, exceeded total GDP growth by 200 basis points in 2022 and 120 basis points in the first half of 2023 — the widest growth rate gaps within the past 15 years. This out-performance led to a significant increase in demand for distribution centres, warehouses, manufacturing facilities and data centres, resulting in fast-declining vacancy rates and double-digit rent growth across Canada's major metros over the past two years.

Demand remains in good shape, despite near-term headwinds. A shift in consumer preferences toward online shopping and the domestication of supply chains have likely become key structural forces that drive long-term demand growth in Canada's industrial sector. While these forces are forecast to persist over the upcoming years, there are early signs that industrial demand is facing short-term headwinds due to elevated interest rates. Calgary, Montreal, Ottawa and Vancouver all saw more industrial spaces get vacated than occupied, which resulted in periods of negative net absorption so far this year. For 2023 as a whole, total net absorption in Canada will remain positive, but will likely register an annual decrease compared to the 2022 level.

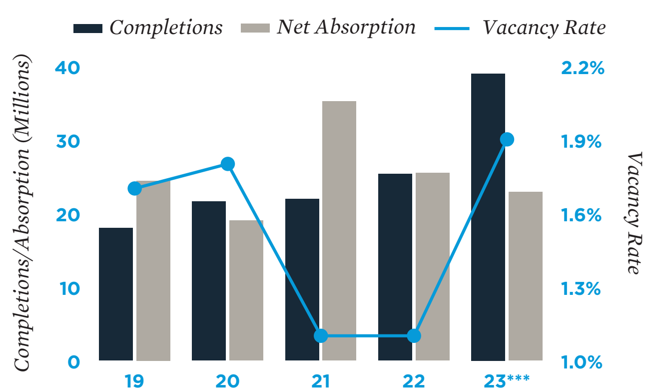
Supply to mark record growth in 2023. New construction in many metros has shifted from build-to-suit developments to speculative projects, as builders are confident that new openings will be absorbed quickly after delivery due to tight vacancy rates across Canada. Since 2020, annual completions have consistently risen above 1.0 per cent of total inventory, with total stock expected to grow by another 2.0 per cent this year. Total completions are forecast to reach 39 million square feet, a 54 per cent annual increase. Almost all key markets, except Edmonton, will see an advancement in deliveries. Toronto will contribute roughly 15 million square feet to the total stock, the highest level of all major metros, whereas Vancouver is expected to see the greatest year-over-year increase of approximately 100 per cent.

Fundamentals to end the year on a high note. Moderating demand and rising new supply will translate to a year of rising vacancy. After increasing to 1.6 per cent as of the third quarter of 2023, the national average vacancy rate is estimated to end the year at 1.9 per cent. Calgary will see the greatest increase at 120 basis points, whereas Edmonton will hold the highest vacancy rate. This rising share of available space will offer tenants much-needed relief, especially in tight markets like Toronto and Vancouver. The influx of new high-quality supply and still-low vacancy rates should also maintain rents on an upward trajectory. However, the rate of increase will likely moderate to single digits in four out of the seven key metros due to easing demand. On the national level, the average asking rent is estimated to increase 9.2 per cent year-over-year, sitting just under $16 per square foot by the end of 2023.

Industrial-Intensive Sector Outperforms

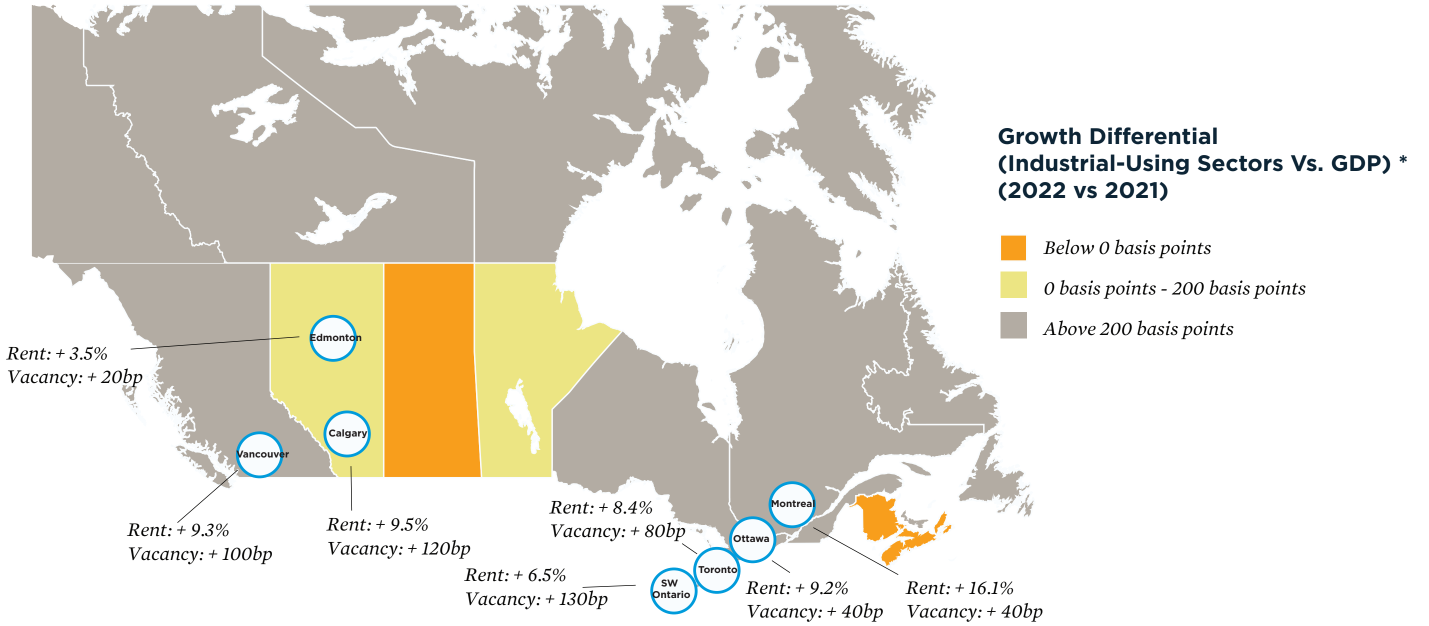


Supply and Demand



** Industrial-using sectors include Transportation & Warehousing and Manufacturing. Growth gap is between output of the industrial-using sectors and total output; ** As of June 2023, 12-month rolling average;*
**** Forecast*
Sources: IPA Research Services; Altus Data Solutions; Statistics Canada

2023 Industrial Rent Growth and Vacancy Change Forecasts



** Industrial-using sectors include Transportation & Warehousing, and Manufacturing*
Sources: IPA Research Services; Altus Data Solutions, CoStar Group, Inc.; Statistics Canada

WESTERN CANADA

- **Calgary, Alberta:** With below-national-average rents, Calgary's industrial sector benefits from demand spilled over from the Vancouver market, which was near zero vacancy last year. Combined with its proximity to multiple ports in British Columbia, the metro is becoming one of the most important distribution hubs in Western Canada. Construction activity is ramping up markedly, which is expected to elevate the vacancy rate and soften rent growth in 2023.

- **Edmonton, Alberta:** Edmonton's vacancy rate sat 200 basis points below its pre-pandemic level as of September 2023, which reflects surging demand over the past few years. For the remainder of 2023, however, supply growth will put slight upward pressure on the vacancy rate. Over the long-term, the metro's plan to build a low-emission hydrogen economy and its easy access to the Ports of Vancouver and Prince Rupert will continue to maintain healthy fundamentals.

- **Vancouver, British Columbia:** Home to one of the most important deep-water ports in North America, Vancouver saw its vacancy rate reach a historic low last year, due to unmitigated demand outpacing new supply growth. In 2023, however, elevated interest rates are likely to cause demand to moderate, putting upward pressure on vacancy. The metro is also estimated to see completions double last year's level, which is prompted by surging demand during the pandemic. This will provide some relief for tenants looking for rentable spaces.

EASTERN CANADA

- **Montreal, Québec:** Since hitting a record low in 2021, the vacancy rate has been trending upward, due to waning demand caused by rising interest rates. By the end of 2023, an influx of new supply will push vacancy slightly above the pre-pandemic level. The metro is seeing rising demand for data centres, especially following the recent boom in artificial intelligence technology. This will likely be a new driver for long-term industrial demand in the upcoming years.

- **Ottawa, Ontario:** Leasing activity took a hit in the first half of 2023, due to rising interest rates; however, early data suggests that net absorption turned positive in the second half. Combined with still-limited new supply, vacancy should end the year below 2.0 per cent.

- **Southwestern Ontario:** The region will continue to attract tenants priced out of the GTA market with its more affordable nature, but near-term economic headwinds are causing a mild uptick in vacancy. Similar to other markets, the metro will see an influx of new construction, driven by heightened demand over the past few years.

- **Toronto, Ontario:** Toronto's industrial market ended 2022 with near-full occupancy; however, a surge in completions is gradually lifting the vacancy rate. The market will see the most completions, roughly 15 million square feet, of all major metros, providing tenants with more options. Rents will remain on an upward trajectory, which is projected to register another year of double-digit growth.

2023 Forecast: Vacancy Rate Drifting Higher Amid Rising Construction

EMPLOYMENT

1.8% increase Y-O-Y

- Canada's labour market will remain healthy in 2023, as elevated population growth from immigration continues to aid job creation. Compared to last year, hiring activity will slow due to elevated interest rates.

CONSTRUCTION

39 million square feet completed

- Total completions are estimated to increase 54 per cent, which is spurred by surging demand over the past few years. Toronto will see the most completions, while Vancouver will experience the greatest rate of increase.

VACANCY

80 basis point increase Y-O-Y

- The rising vacancy is mainly due to an influx of new supply and softening demand caused by elevated interest rates. Nevertheless, Canada's industrial sector will still end 2023 with a vacancy rate below 2 per cent.

ASKING RENT

9.2% increase Y-O-Y

- Industrial rents will remain on an upward trajectory, due to a still-low vacancy rate and a large addition of high-quality spaces. The rate of increase, however, will moderate to single digits as leasing activity eases.

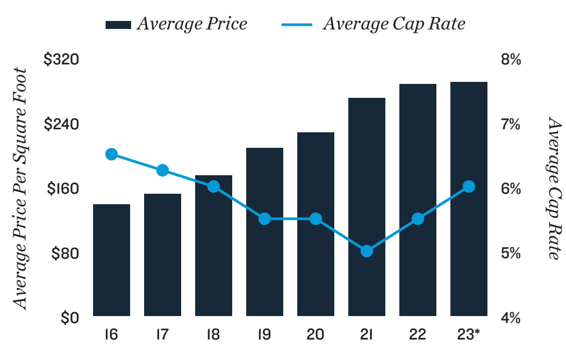
2023 INVESTMENT OUTLOOK

- **Investment activity to remain subdued amid elevated interest rates.** The trailing 12 months through the second quarter of 2023 saw total dollar volume fall 34 per cent year-over-year as rising interest rates pushed many market participants to the sidelines. With capital markets uncertainty showing signs of abating in the second quarter, dollar volume increased 55 per cent quarter-over-quarter. While transaction volumes are likely to remain muted compared to last year's level, activity is likely to gain momentum heading into next year as borrowing shows further signs of stabilizing.

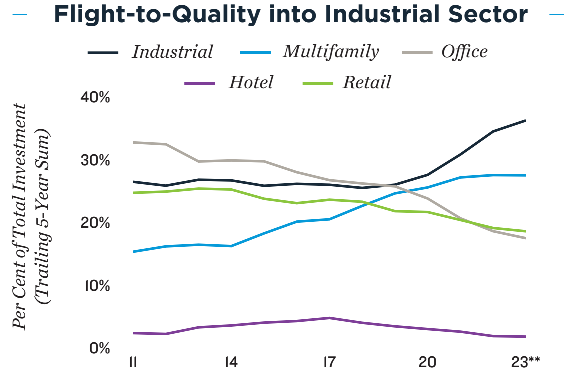
- **Average sale price begins to stabilize, while cap rates trend up.** As of the second quarter, the average sale price was essentially unchanged compared to the end of last year. Vancouver continued to be the highest-priced market, with the average cost hitting $600 per square foot. With price growth beginning to ease, coupled with still-elevated rent growth and rising interest rates, the average cap rate ticked up 50 basis points to around 6.0 per cent.

- **Flight-to-quality well underway.** A changing work style, evolving consumer behaviour and the nearshoring of supply chains have resulted in underutilized downtown office buildings and near-full occupancy in industrial properties. Investors are reacting to these trends by relocating funds from riskier properties like downtown offices and urban retail to assets that enjoy robust rent growth, such as distribution centres and warehouses. The industrial sector now attracts the most CRE investments in Canada, with its share of total dollar volume transacted increasing from 25 per cent in 2019 to 36 per cent as of June 2023.

Industrial Investment Sales Trends



Flight-to-Quality into Industrial Sector



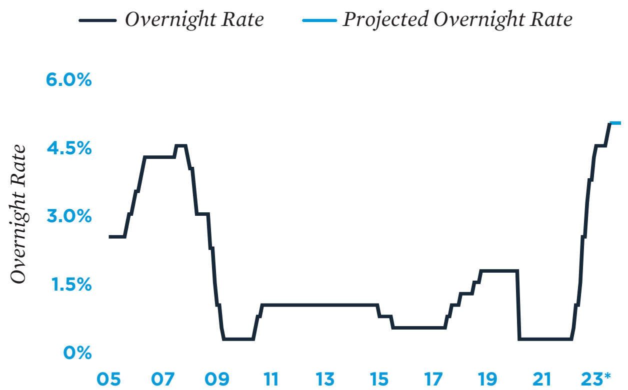
** Through 2Q; ** Through 1Q*
Sources: IPA Research Services; Altus Data Solutions; CoStar Group, Inc.; Statistics Canada

Interest Rate Hike Pause to Aid Investment; Inflation Acceleration Still Poses Major Threat

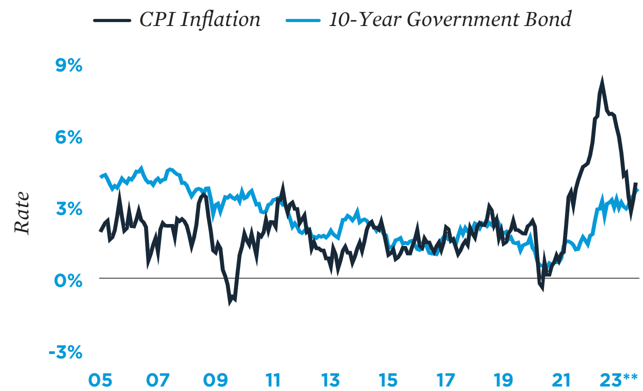
Interest rates likely to stabilize amid weakening economic performance, while oil price gains raise inflation risks. After a surprisingly well-performing economy recorded in the first three months of the year, economic momentum showed signs of slowing in the second quarter. GDP contracted unexpectedly between April and June, real consumer spending edged lower from May to July, and the unemployment rate increased 60 basis points from its April level. These are encouraging signs that elevated interest rates are working their way through the broader economy, which prompted the Bank of Canada to hold interest rates unchanged in September. As the current tight monetary environment is expected to exert further downward pressure on interest rate-sensitive sectors, market participants now anticipate no more rate hikes for the remainder of 2023. However, the Central Bank has left the door open for further tightening in the near term if necessary. Recent developments are indeed increasing the odds of such events. Since July, oil prices have rallied more than 25 per cent, due to a stronger-than-expected U.S. economy and supply cuts announced by major oil producers. Inflation ticked up again in July and August as a result, falling above the Bank of Canada's target once again. If this upward price movement persists for longer, the monetary authority will not hesitate to resume its interest rate hiking cycle at future policy meetings.

Rate pause to encourage investment, but dimming economic performance may cap upside potential. Evident in the first half of 2023, stabilizing interest rates between February and May aided investment activity. Total dollar volume invested in industrial properties in the second quarter rose by 55 per cent compared to the previous quarter, and the number of transactions recorded a similar increase. With broad expectations that the BoC will hold rates unchanged for the remainder of the year, large volumes of deployable capital may again re-enter the market, continuing the recovery seen in the second quarter. However, if Canada's economy underperforms, CRE fundamentals may deteriorate at a fast pace. This could provide some additional risk that commercial real estate investors may need to consider.

Overnight Rate Likely to Stabilize



Inflation and Interest Rate Trends



** Forecast through December 2023; ** Inflation through August, 10-year government bond yield through September 21*

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

Regional Managers

Mark Paterson
Regional Manager, Vice President | Toronto, Ottawa
Tel: (416) 585-4650 | mark.paterson@marcusmillichap.com

Michael Heck
Regional Manager, Vice President | Vancouver, Edmonton, Calgary
Tel: (604) 398-4379 | michael.heck@marcusmillichap.com

Prepared and edited by:
Frank Zhao
Research Associate, Canada | Research Services
Luke Simurda
Director of Research, Canada | Research Services

For information on national retail trends, contact:
John Chang
Senior Vice President, Director | Research & Advisory Services
Tel: (602) 707-9700 | jchang@ipammi.ca