SPECIAL REPORT
CANADA COMMERCIAL REAL ESTATE RISK

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

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Commercial Real Estate Poses Small and Manageable Risks to Canada's Financial System

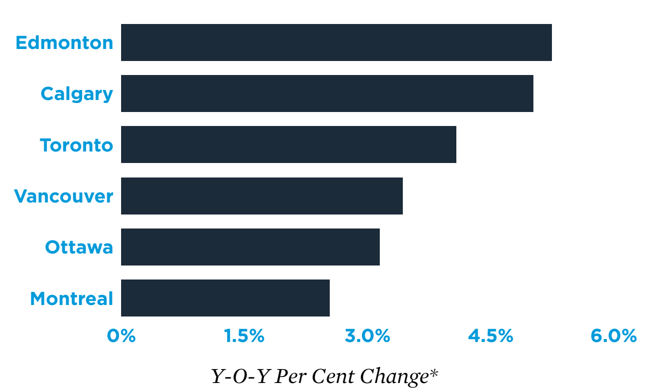
Commercial properties under heightened assessment. The recent crisis of New York Community Bank sparked a fresh round of debate over the health of U.S. regional banks. The institution incurred an unexpected quarterly loss largely due to its exposure to rent-regulated, multifamily properties, which led to a 70 per cent reduction in its dividend in January. In response, the bank has reportedly closed a $1 billion capital infusion deal alongside a change in its board members. While the combination of circumstances troubling NYCB is particular to that institution, its troubles have nevertheless raised concerns regarding commercial real estate loan performance both in the U.S. and to the north. Due to differences in regulations and lending practices between the two countries, however, the risks exposed by the NYCB crisis are largely mitigated in Canada.

Distinctive nature of NYCB crisis. A unique red flag that pushed NYCB into crisis was its high exposure – roughly 22 per cent of its total loans – to rent-regulated multifamily properties. In 2019, New York City changed its tenant protection laws, under which landlords can no longer remove a unit from rent stabilization after a vacancy if the rent has reached a certain dollar threshold. This means that owners of some rent-stabilized apartment buildings cannot charge new tenants market rate. In addition, the vacancy bonus, which allowed owners of rent-stabilized apartments to increase rents up to 20 per cent between tenancies, was also eliminated. As elevated interest rates and persistent inflation have raised debt servicing and maintenance costs, this new law has limited revenue growth for many owners. Coupled with declining property values, 8.3 per cent of NYCB loans tied to multifamily properties were at higher risk of default.

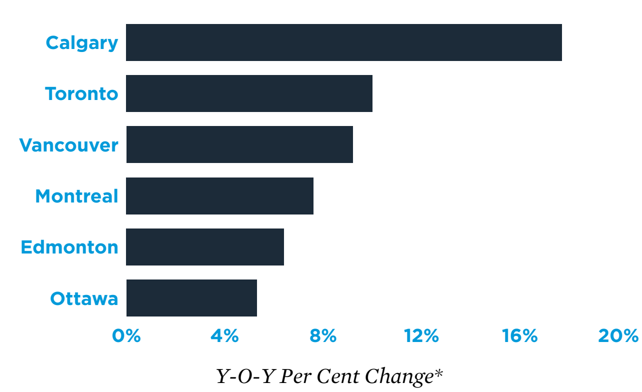
Multifamily owners in Canada face different situation. Unlike the rent regulation in New York City, rent control policies across Canada generally allow owners to charge market rate when a unit is vacated. Although some regions, like Ontario, have seen efforts to do away with vacancy decontrol measures, such attempts have been unsuccessful. Canadian metros also benefit from robust population gains that New York City lacks, which has weighed on rent momentum there. Coupled with stricter rent regulations, New York's average effective rent increased merely 1.5 per cent in 2023, which was dwarfed by roughly 10 per cent increases witnessed in Toronto and Vancouver. In comparison, rent growth in Canada has supported large revenue increases in recent years, undergirding broadly sound financials.

Low default risk for commercial mortgages in Canada. The commercial real estate sector currently poses a small and manageable risk to Canada's financial industry. This is evident in low delinquency rates of commercial mortgage-backed securities, distinctive lending rules for commercial mortgages and the financial industry's low exposure to commercial real estate loans. While loan details are not publicly avialable for all outstanding commercial mortgages, data from Morningstar DBRS on commercial mortgage-backed securities tied to all property types shows that Canada's delinquency and special servicing rates have historically remained well below 2.0 per cent, a rate that is significantly lower than the U.S. counterpart. In addition, Canada's rates have been consistently less volatile during economic downturns relative to rates seen in the U.S.

Canada Saw Elevated Population Growth



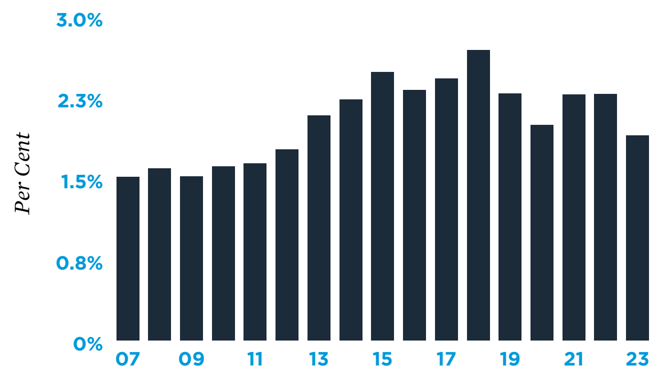
Apartment Rent Rose Sharply in Canada



** As of 2023*

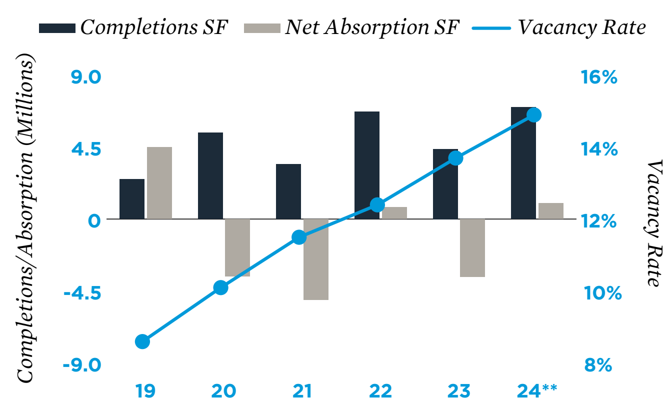
Sources: IPA Research Services; Altus Data Solutions; BoC; CoStar Group, Inc.; Morningstar DBRS; OFSI; RBC; Real Capital Analytics; Statistics Canada; U.S. Census Bureau

Share of CRE Loans in Total Bank Assets



Top Risks for Canada's Financial Market in 2023

Office Supply and Demand



Different lending standards in Canada. Relative to the U.S., Canada's lower default risk can be attributed to the country's distinctive lending rules. In Canada, the majority of CMBS loans are guaranteed, whereras most CMBS loans in the U.S. are non-recourse, meaning that lenders are not allowed to pursue anything other than the collateral if defaults happen. CMBS also makes up a lower share in the commercial mortgage loan market in Canada. This results in the majority of commercial mortgages remaining on lenders' balance sheets for the entire duration of the loan, which incentivizes scrutiny over borrowers' debt servicing capabilities. Furthermore, in the absence of a sizable regional bank sector, large established banks and other financial institutions like credit unions and insurance companies are the main lenders in Canada. Given fewer lending sources, borrowers in Canada are encouraged to maintain a good reputation by fulfilling their debt obligations.

Impact of a potential CRE credit event likely to be limited. The Canadian banking sector's small exposure to commercial real estate also plays an important role in maintaining financial stability in times of distress. Nonresidential mortgages currently account for roughly 2 per cent of the total assets of all chartered banks in Canada. Furthermore, for the entire private nonfinancial sector – which includes household and nonfinancial corporates – commercial mortgages constitute less than 6 per cent of all credit liabilities. Given this small exposure, combined with a conservative lending environment, widespread defaults appear to be unlikely in the near term. The limited defaults that do occur will likely have only a marginal impact on Canada's financial system, although some individual lenders with higher exposures may have to absorb greater losses.

Office sector posing biggest risk in Canada. While all commercial property types in Canada are facing increased risks due to a more difficult financing environment, the office sector is experiencing more significant challenges. Rising inventory and sluggish demand due to greater adoption of hybrid work have pushed up vacancy rates and weighed on property values, leading to an increasing number of strategic defaults. This development has created harsher financing conditions for office owners, especially those who hold Class B and C assets. Consequently, property loan defaults tied to office buildings are currently of greatest concern in Canada.

The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, express or implied, may be made as to the accuracy or reliability of the information contained herein. This is not intended to be a forecast of future events and this is not a guaranty regarding a future event. This is not intended to provide specific investment advice and should not be considered as investment advice.

** The risk index is a weighted average of the ranking of each risk category; ** Forecast*

Sources: IPA Research Services; Altus Data Solutions; BoC; CoStar Group, Inc.; Morningstar DBRS; OFSI; RBC; Real Capital Analytics; Statistics Canada; U.S. Census Bureau

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