NATIONAL REPORT
CANADA RETAIL

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

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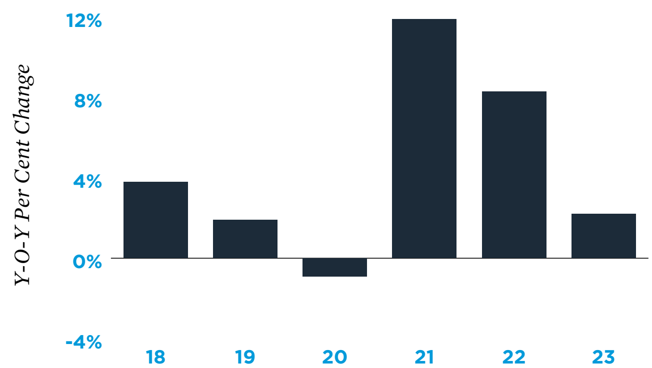
Retail Investment Poised for Comeback Amid Sound Sector Performance and Impending Rate Cuts

Healthy retail fundamentals to persist in 2024. Canada's retail vacancy rate fell to its lowest level on record last year. Strong population growth propelled overall demand, keeping net absorption on par with the 2022 level, despite elevated interest rates. Construction activity, however, was impaired by tough financing conditions, which resulted in a 12 per cent contraction in new supply. In 2024, moderating consumer demand will lead to a more visible decline in net absorption, as elevated borrowing costs continue to be absorbed and Canada's consumer base expands at a slower pace, due to recent changes in immigration policy. A significant increase in deliveries in Edmonton and Montreal will push 2024's completions ahead of last year's. These factors, combined, are expected to put a pause on the falling vacancy rate, helping it stabilize below 2.0 per cent.

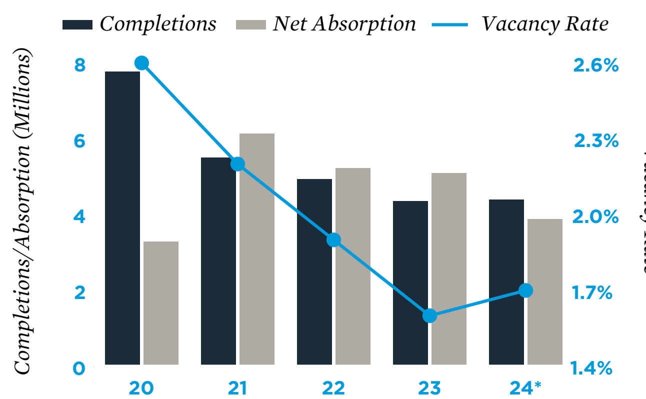
Retail sector to face short-term challenges. Canada's economy expanded by 1.1 per cent in 2023, as growth in consumption offset weak investment. This helped the nation avoid a technical recession, or two consecutive quarters of contraction. Despite remaining in positive territory, Canada's GDP growth has decelerated sharply — down from 5.3 per cent in 2021 and 3.8 per cent in 2022. As elevated financing costs continue to sweep through the economy, near-term momentum is likely to slow further. Most economists currently expect growth to fall below 1.0 per cent in 2024. Faced with rising unemployment and higher mortgage payments, households are tightening their budgets. Consequently, retail sales growth is on track to inch lower in the first half of 2024. Rate cuts currently anticipated to start by mid-year will likely drive a recovery in consumer spending in the final two quarters.

Standout markets buck national trend. Tailwinds for Alberta's economy may help the province outperform the national average again this year. Despite changes to Canada's immigration policy limiting new admissions, Alberta will still see its international student population grow in 2024. This will complement domestic in-migration patterns, solidifying Alberta's consumer base. Elevated oil prices and the expansion of the Trans Mountain Pipeline will continue to help insulate the province's economy from the impact of elevated interest rates, leading to above-average job gains and income growth. With these demographic and economic forces supporting retail space demand, Calgary and Edmonton are expected to be the only two major metros to see lower retail vacancy rates in 2024.

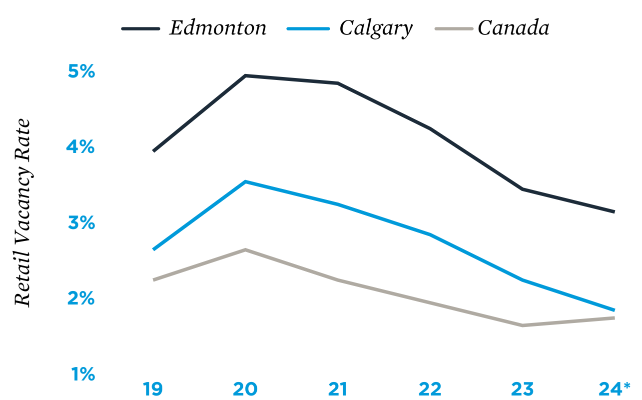
Canada Total Retail Sales



Supply and Demand Trends

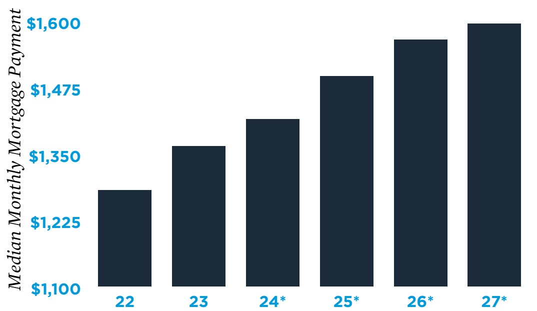


Alberta's Vacancy to Move Lower in 2024

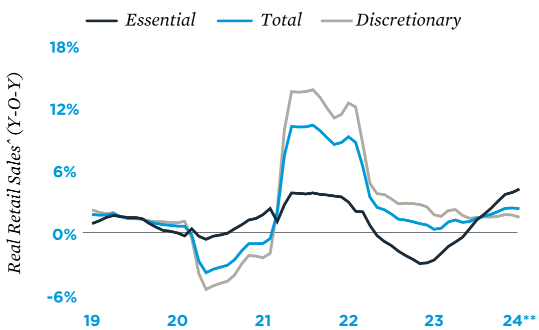


* Forecast
Sources: IPA Research Services; CoStar Group, Inc.; Statistics Canada

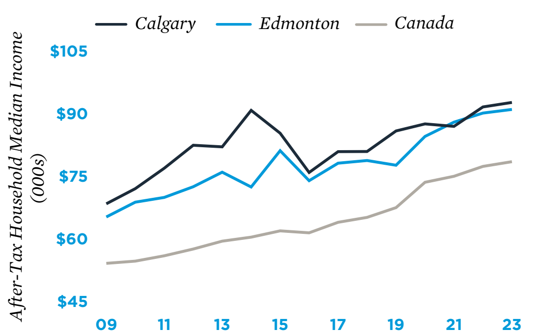
Consumers Facing Higher Interest Payments



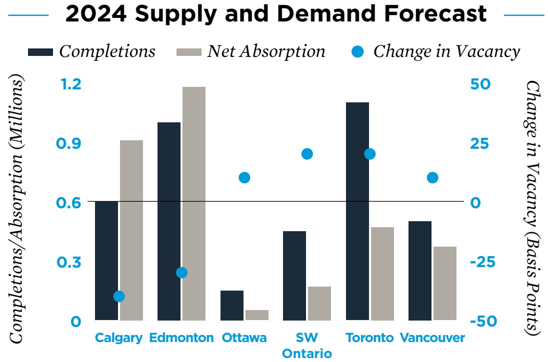
Essential Sales Driving Total Retail Growth



Higher After-Tax Income for Alberta Residents



2024 Supply and Demand Forecast



Key Retail Sector Trends

Consumers adapting to macro challenges. Despite falling headline inflation, high shelter costs are putting more strain on consumers. At the end of 2023, 43 per cent of mortgage holders experienced higher interest payments, with the median monthly payment having increased 14 per cent since the first rate hike. As higher rates kick in at future renewals, it is estimated that 60 per cent of all mortgages will be subject to a higher payment by the end of 2024, and the median monthly cost will hover 19 per cent above its pre-rate hike level. For non-homeowners, rent increases have long outstripped overall price growth as well. In response, consumers continue to adjust their shopping habits by spending less at restaurants, searching for sales, and buying groceries less often but in larger quantities.

Preference for essential retail strengthens suburban fundamentals. In 2023, essential retail became the driving force for total retail sales growth. Adjusted for inflation, sales at gas stations increased the most by 10 per cent year-over-year. Grocery and convenience stores saw annual sales nearly break even, compared to an almost 7.0 per cent fall in the prior year. Health and personal care operators also witnessed steady upward momentum. This translated into healthy space demand for suburban properties, where essential retail offerings are highly concentrated. In 2024, this trend will likely persist as consumers brace for a slowing economy, maintaining low retail vacancy rates outside Canada's urban cores.

Major Market Overview

Western Canada. Retail performance in this part of Canada stands out, mainly due to Alberta's strong economic prospects in 2024. Besides the oil segment supporting solid sector fundamentals, Calgary will see major infrastructure improvements in its urban centre. Coupled with a falling office vacancy rate, foot traffic is expected to rise, benefiting downtown retailers. Residents in Edmonton are enjoying a higher disposable income compared to the national average, thanks to a lower debt burden from better housing affordability. This will encourage new retailers to enter the local market. In Vancouver, normalizing tourist traffic and new office developments will continue to fuel retail leasing demand, helping the metro withstand looming economic uncertainty.

Eastern Canada. Leasing demand in this region is projected to soften, due to elevated interest rates. Net absorption is estimated to end the year below new construction, resulting in a mild increase in vacancy rates. Consumers in Toronto are redirecting spending toward necessity-based products, supporting neighborhood centres serving communities with strong population growth. Relatively stable public sector employment and high-paying tech jobs in Ottawa will help maintain resilient consumer spending amid the current high-cost environment. In Southwestern Ontario, the enhancement of the region's public transit system will offer greater connectivity to Toronto, attracting residents seeking less costly living options. This will expand the local consumer base, which bodes well for the metro's long-term retail sector fundamentals.

** Projections from the Bank of Canada; ** As of January; ^12-month average*
Sources: IPA Research Services; Bank of Canada; CoStar Group Inc.; Statistics Canada

2024 Forecast

EMPLOYMENT

0.6% increase Y-O-Y

- The job market is expected to soften in the first half of 2024 as elevated interest rates slow hiring. This will allow the BoC to lower rates in the summer, which will facilitate a recovery in employment in the second half.

CONSTRUCTION

4.4 million square feet to be completed

- New projects in Toronto, Montreal and Edmonton will contribute to the majority of this year's new construction. In other markets, completions will be limited, remaining well below 1.0 million square feet.

VACANCY

10 basis point increase Y-O-Y

- Softening consumer demand is projected to impact leasing activity and result in a slight increase in the vacancy rate. Alberta, however, will likely continue to see vacancy shrink, due to its strong economic growth.

ASKING RENT

3.1% increase Y-O-Y

- The average asking rent is expected to remain on an upward trajectory, due to still-low vacancy rates across Canada. However, the rate of increase will decelerate as available options increase slightly in the market.

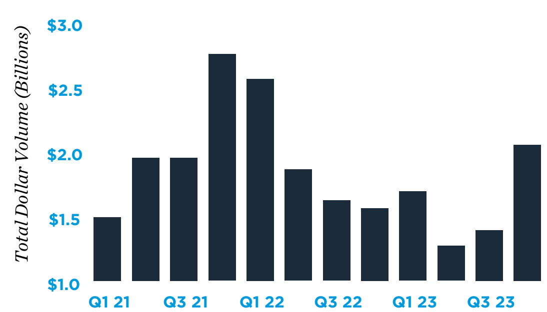
2024 Investment Outlook

- **Investor sentiment on a recovery path.** Following a sharp decline in early 2023, total dollar volume rose quickly in the second half, ending the final quarter with a 31 per cent annual increase. This upward momentum was primarily driven by a significant increase in Ontario, highlighted by the sale of the Vaughan Mills Shopping Centre, Pickering Town Centre and Conestoga Mall. Despite an overall decline in total dollar volume on the national level, Alberta saw an increase in investment, attributed in part to its strong economy and fast-growing population.

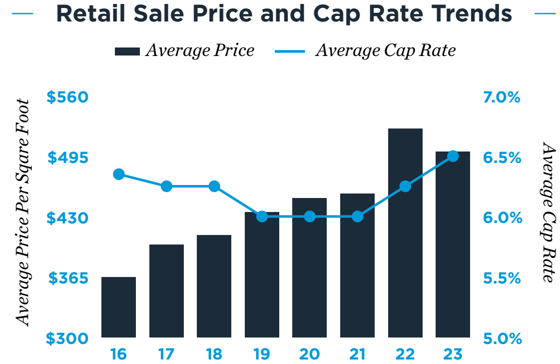
- **Lower prices and higher interest rates uplifted cap rates**. Elevated interest rates and tightening lending practices continued to be a catalyst for price discovery in 2023. Moderating investment demand put downward pressure on property prices, leading to the first year of decrease since 2017. The average sale price retreated the most in Ottawa by 7.8 per cent, as total dollar volume transacted dropped by nearly 50 per cent. Cap rates rose on the back of rising interest rates and sale price cuts, with the annual average approaching 7.0 per cent.

- **Select retail assets outperforming.** Food-anchored neighbourhood centres have become one of the most preferred asset types for investors. This retail format typically serves suburban communities, which tend to house necessity-based tenants and have experienced increased foot traffic, due to remote work arrangements and elevated population growth. As near-term uncertainty grows, enthusiasm for this retail type is expected to continue building in 2024.

Retail Investment Sales Trend



Retail Sale Price and Cap Rate Trends



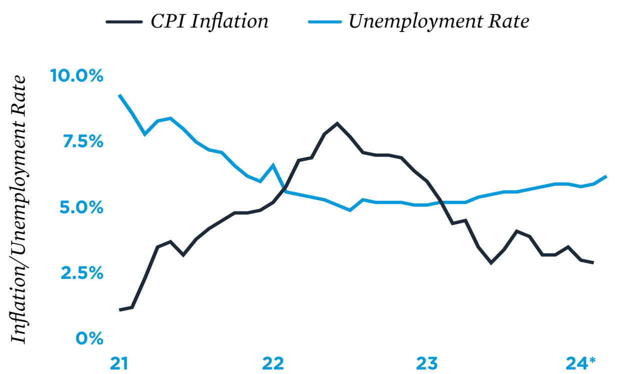
Sources: IPA Research Services; Altus Data Solutions; CoStar Group, Inc.; Statistics Canada

Transaction Activity to Gain Momentum in Second Half with Better Credit Conditions*

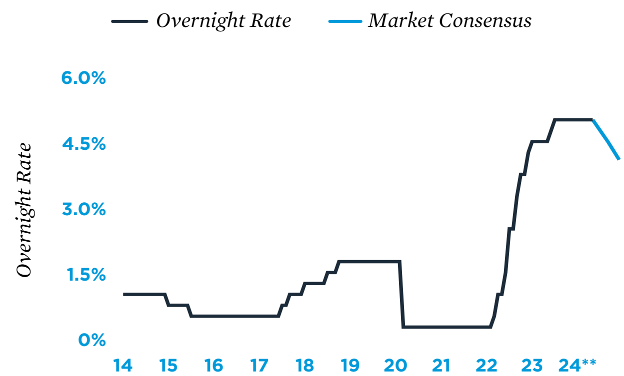
Bank of Canada expected to lower rates by mid-year. Following the Bank of Canada's March meeting, key economic data continued to point to slower economic growth and cooling inflation. In March, the labour market lost its upward momentum, registering its first employment loss in eight months. The jobless rate rose to its highest level since December 2021 as firms struggled to absorb Canada's fast-expanding labor pool. February's inflation reading also showed a broad-based weakening of inflationary pressure. The headline rate surprised to the downside, inching lower within the Bank of Canada's target range. The three-month annualized pace decelerated sharply to 1.3 per cent, suggesting that sequential inflationary pressure has eased significantly. In addition, core inflation measures sustained their downward trend. While still elevated, these rates are expected to fall below the 3.0 per cent threshold in the months ahead. With increasing evidence demonstrating that Canada's economy is slowing and inflation is trending down, it is now widely believed that the BoC will begin cutting the overnight rate in June.

Recovery in investment may be imminent as rate cuts near. Apart from higher borrowing costs and stricter lending requirements, investors are currently seeking higher yields to compensate for the elevated cost of capital. This has not only dampened overall investor enthusiasm, but has also reduced the number of feasible projects on the market. In 2023, the number of retail deals of all sizes dwindled as a result, with the greatest decrease observed in mid-size transactions valued between $10-$20 million. The highly anticipated rate cuts, if materialized, will bring about easier financing conditions and also help increase the spread between cap rates and cost of debt. This is expected to spur investment activity in the second half of 2024, with mid-sized deals likely leading a recovery in total dollar volume. As Canada's retail sales are now mainly supported by population growth, investors may continue to pivot toward assets and areas experiencing strong resident gains, such as suburban food-anchored strip malls and grocery-anchored neighborhood centres. Metros with projects aiming to revive the urban core, like Calgary's BMO Centre expansion, will likely see foot traffic recover at a faster pace in their downtown markets, which will also help improve overall investor confidence.

Inflation and Unemployment Rate Trends



Interest Rates to Fall Starting Mid-2024



** Inflation rate as of February, unemployment rate as of March;*
*** Market consensus from April is calculated as an average of the latest forecasts from TD, RBC, BMO, CIBC, Scotiabank and National Bank*
Sources: IPA Research Services; Altus Data Solutions; Bank of Canada, Statistics Canada; TD; RBC; BMO; CIBC; Scotiabank; National Bank

Regional Managers

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

Kevin Marshall
Regional Manager | Montreal
Tel: (438) 394-6370 | kevin.marshall@marcusmillichap.com

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

Prepared by:
Frank Zhao
Research Associate, Canada | Research Services

Edited by:
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 | john.chang@marcusmillichap.com