NATIONAL REPORT
CANADA OFFICE

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

2Q/25

Sector Recovery Underway, but Investor Confidence Remains Elusive

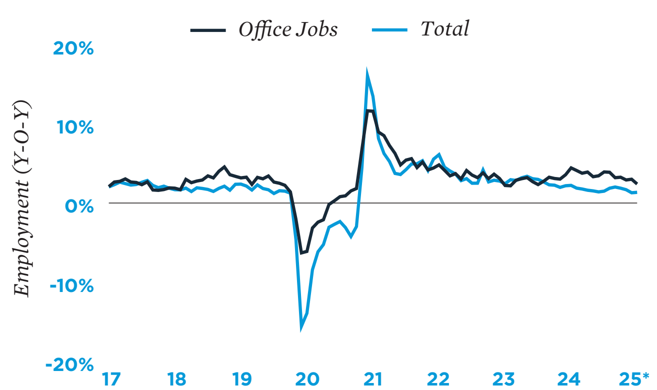
Recovery to resume after early-year disruptions. After six consecutive quarters of rising space demand, preliminary data indicates that the office sector is experiencing a setback in the second quarter. The trailing 12-month net absorption declined to 2.7 million square feet, likely driven by a sudden shift in business sentiment amid escalating trade tensions, which halted office footprint expansion nationwide. United States trade policy will remain a key factor shaping the office sector outlook this year. Easing tensions and ongoing trade talks between Canada and the U.S. since mid-April have offered hope that the worst days of tariff threats may now be behind us. The resilience of office-using employment, a supportive policy environment and abating supply-side pressures suggest that the office sector's recovery could get back on track following a turbulent start to 2025.

Office utilization on the rise. Despite a rising unemployment rate, office-using sectors continue to grow. In the first five months of this year, 54,400 office jobs were created, driven by gains in finance, insurance, real estate, public administration and professional services. Year-over-year employment growth in the office-using sector has also outpaced the overall job market since January 2024. At the same time, businesses are ramping up return-to-office mandates. RBC and Scotiabank, for example, will require at least four days of in-office work starting this September. In Toronto, office utilization has been rising steadily, reaching roughly 80 per cent of pre-COVID occupancy levels by mid-May. This increase in organic demand is expected to keep fuelling the office sector's recovery through the remainder of 2025.

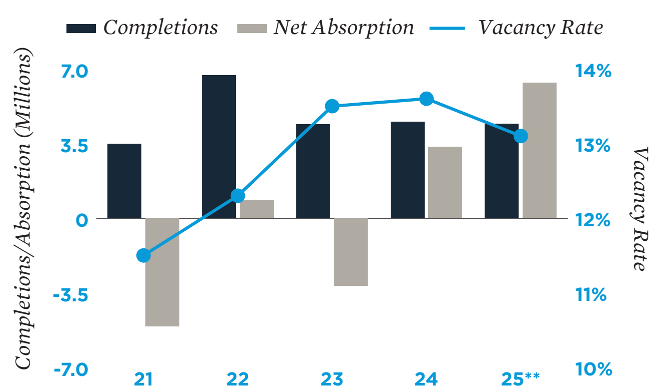
Construction pipeline winding down. While construction activity remains muted in most metros, Toronto and Vancouver are still projected to see 4.3 million square feet of additions this year. Completion levels are anticipated to decline significantly starting next year, however, with most new projects consisting of small- to medium-scale mixed-use buildings. In addition to fading supply-side pressures, office repositioning continues to reduce inventory across Canada. The most common conversions comprise hotels, condominiums and purpose-built rentals. In Calgary – home to the country's most substantial downtown office conversion program – the municipal government committed an additional $52.5 million to the initiative late last year. This investment is expected to play a key role in gradually normalizing office vacancy over the coming years.

Vacancy to decline and rents to rise. Amid recovering demand and fading supply growth, the national office vacancy rate is set to record its first annual decline this year since 2019. Calgary, Edmonton and Southwestern Ontario are projected to lead this improvement, while vacancy may still edge up slightly in other metros. With leasing activity strengthening, downward pressure on rents could abate. Yet as more high-quality space is absorbed, a growing share of Class B and C inventory still on the market could put pressure on rents, resulting in a relatively muted increase in asking rates. That said, if the sector's recovery broadens and demand strengthens across all asset classes, rent growth could accelerate once momentum picks up in the lower-tier segment of the market, which could potentially occur over 2026.

Office Jobs Outgrowing Total Employment



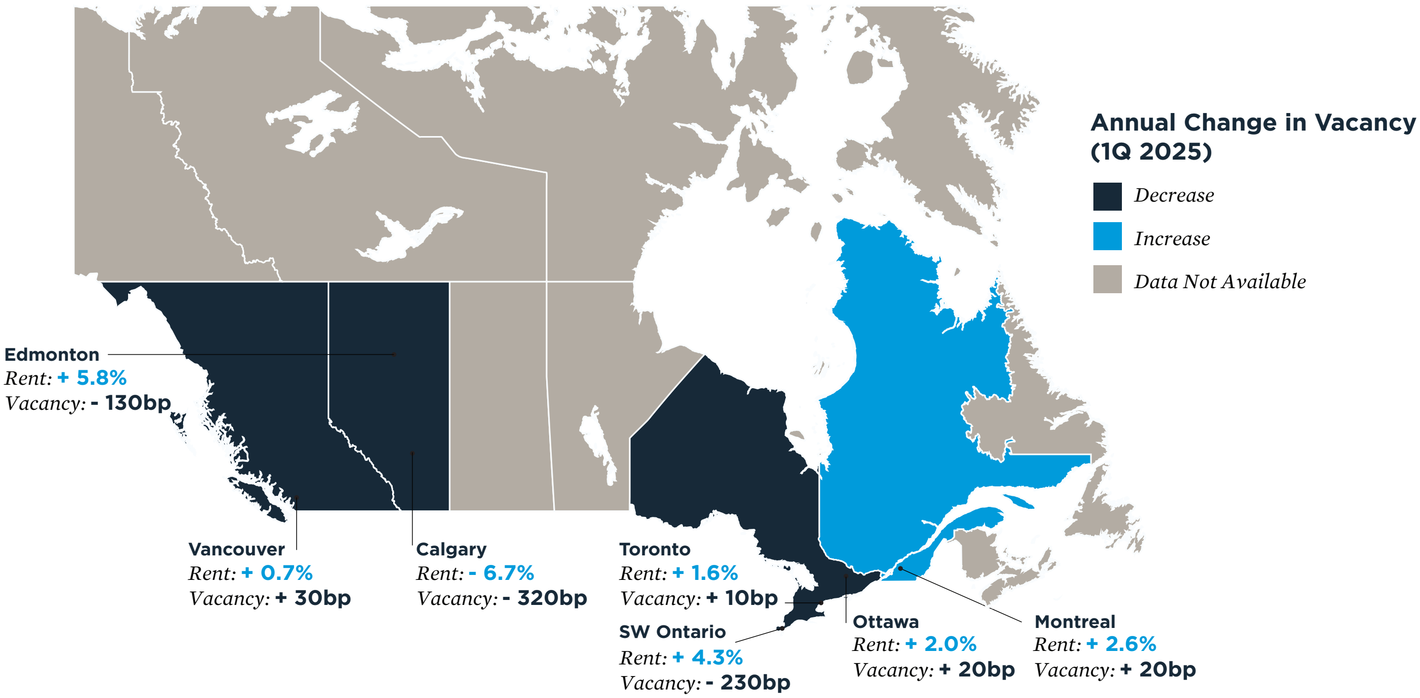
Office Supply and Demand



** Through May; ** Forecast*

Sources: Altus Data Solutions; Statistics Canada; Strategic Regional Research Alliance

2025 Rent Growth and Vacancy Change Forecasts



Sources: Altus Data Solutions

WESTERN CANADA

- **Calgary, Alberta:** Positive momentum in office demand continues to build. In the first quarter of 2025, net absorption rose to 1.2 million square feet, bringing the vacancy rate down to a nine-year low. The metro is projected to see the largest decline in vacancy among major Canadian markets this year. Nevertheless, if trade tensions escalate and lead to a significant drop in oil prices, office demand could come under pressure, potentially stalling the sector's recovery.

- **Edmonton, Alberta:** Office demand has been gradually recovering since 2021. Amid virtually no completions, the vacancy rate has trended lower but stayed above 14 per cent in the first quarter. A handful of buildings in the downtown submarket account for a significant share of the metro's unoccupied office space, however, suggesting that underlying leasing demand across the broader market may be stronger than the elevated headline vacancy rate implies.

- **Vancouver, British Columbia:** Vancouver currently has the lowest office vacancy rate among major metros, with just under 10 per cent of space unoccupied. Construction activity remains muted in downtown but steady in suburban and outlying areas. The only major project currently underway in the downtown core is Westbank's office tower, which is set to be completed in 2029 and will be built above the new Creative Energy steam plant.

EASTERN CANADA

- **Montreal, Québec:** While trade policy uncertainty is weighing on the local economy, the service sector is expected to benefit from lower interest rates this year. Property performance will also be strengthened by a shrinking construction pipeline, as only 60,000 square feet of new space is projected for delivery.

- **Ottawa, Ontario:** Despite the absence of supply-side pressure, the vacancy rate is expected to rise slightly this year, driven by trade uncertainties and a potential slowdown in federal government hiring. Yet even with this increase, Ottawa's office vacancy rate is forecast to remain among the lowest in Canada.

- **Southwestern Ontario:** Office demand will be upheld by growth in the tech and life sciences sectors, assisted by lower interest rates. That said, trade tensions could spill over into the office market. Some office conversions are currently underway, aided by public support such as developer grants and loan forgiveness programs.

- **Toronto, Ontario:** The metro's historic construction cycle is nearing completion, with 2025 poised to mark the final year of elevated deliveries. As of March, only 2.6 million square feet remained under development. This fading construction pipeline is expected to support improved office market performance in the years ahead.

2025 Forecast

EMPLOYMENT

1.0% increase Y-O-Y

- Lower interest rates are expected to bolster employment growth this year, though ongoing trade uncertainty and a slowdown in population growth will temper the pace of expansion.

CONSTRUCTION

4.4 million square feet completed

- Deliveries will decline but stay elevated, with most new builds in Toronto and Vancouver. As the post-pandemic construction cycle winds down, completions are likely to drop off beyond 2025.

VACANCY

50 basis point decrease Y-O-Y

- Vacancy will record its first annual decline since 2019, driven by Alberta and select Ontario markets. Muted deliveries beyond 2025 suggest there may be further room for vacancy to fall if demand remains steady.

ASKING RENT

0.9% increase Y-O-Y

- After last year's decline, marketed office rents will see a modest increase in 2025; however, downside risks remain. A larger share of Class B and C space is still on the market amid the flight to quality.

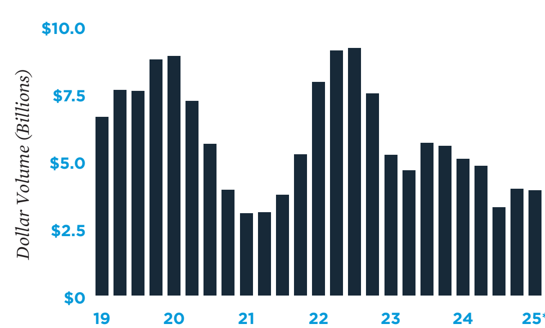
2025 Investment Outlook

- **Property sales fell amid low investor confidence.** Office investment weakened markedly over the past year. While the number of transactions declined only slightly, total dollar volume dropped sharply. On a trailing 12-month basis, volume fell from $5 million in the first quarter of 2024 to $3.8 million in the same quarter this year – a level nearing the post-pandemic low. Investors have been broadly hesitant to expand their office holdings, despite early signs of stabilizing vacancy rates across Canada. Competition from other property types with stronger fundamentals – particularly multifamily and retail – has likely further diminished the appeal of office assets.

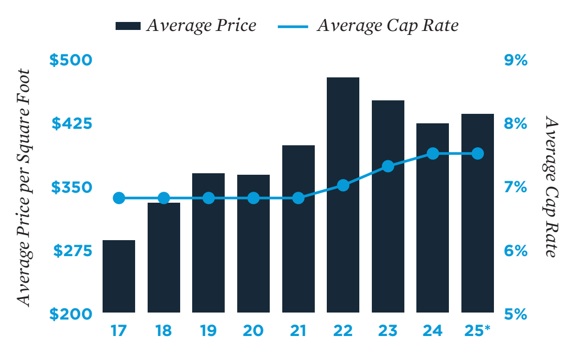
- **Muted deal flow makes pricing tricky and maintains high cap rates.** Compared with last year, the average sale price rose slightly in the first quarter of 2025, likely reflecting reduced investor interest in lower-tier assets. Nevertheless, limited transaction activity in recent years has made pricing office assets challenging. Cap rates have stayed elevated at approximately 7.5 per cent, continuing to signal a high level of perceived risk among buyers.

- **Investors could return if recovery continues.** A sustained improvement in fundamentals will be essential to restoring investor confidence. If trade tensions remain contained, growth in office jobs and higher workplace attendance could pave the way for a rebound in property sales over the coming years. As fundamentals stabilize, higher yields may also offer an attractive entry point for those with a longer-term belief in office space demand.

Office Sales May Be Approaching Bottom



Office Investment Sales Trends



* Trailing 12 months through 1Q

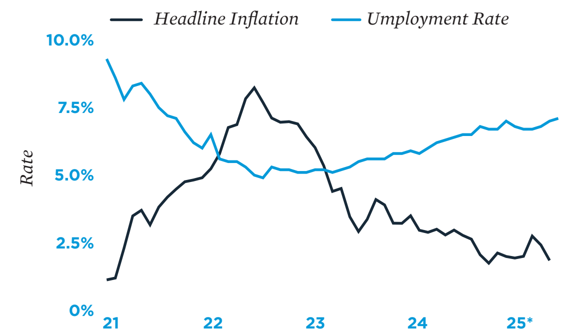
Sources: Altus Data Solutions; Statistics Canada

Financing Costs Remain a Challenge for Investors as BoC Navigates Uncertainties

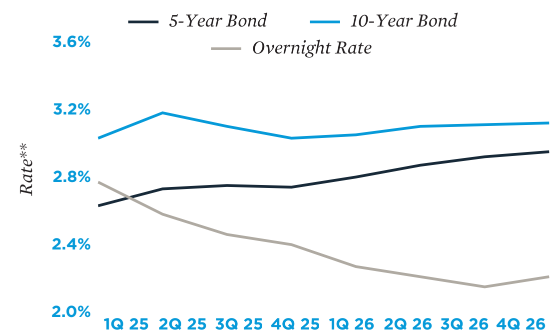
Bank of Canada expected to proceed cautiously. Despite shifting trade policies, Canada has so far avoided the worst fallout from its trade tensions with the U.S. Economists estimate that the strength seen in first-quarter GDP growth – driven by inventory accumulation and tariff front-loading – will likely not carry through the rest of the year. Even so, the latest readings from May's Labour Force Survey suggest the economy continues to eke out job gains, albeit at a slower pace. A recent uptick in core inflation reflects the impact of tariffs, but overall price pressures have eased, helped by the removal of the consumer carbon tax slashing energy costs. These conditions – a modest slowdown in growth alongside still-manageable inflation – led the Bank of Canada to hold interest rates steady in June. Still, the central bank is navigating elevated uncertainty surrounding the effects of tariffs on exports, the spillover into business investment, employment and household spending, and the future trajectory of price growth and inflation expectations. As such, the BoC is expected to proceed cautiously, aiming to support growth while keeping inflation in check. With risks skewed to the downside, the financial market still anticipates additional rate cuts in the second half of 2025, with the year-end rate ranging from 2.25 per cent to 2.5 per cent.

Elevated financing costs a major headwind. Long-term interest rates have stayed elevated so far this year, even with a 50-basis-point reduction in the overnight rate in the first half. The 5-year government bond yield has edged down by less than 10 basis points, while the 10-year yield has actually risen by nearly 15 basis points since December 2024. Persistent inflation risks and upward pressure from U.S. treasury yields have contributed to this dynamic, creating a major challenge for investors across asset classes. Due to higher perceived risks for office assets, however, office buyers are facing even higher borrowing costs than those acquiring assets with stronger fundamentals. This spread may only narrow if leasing demand, vacancy rates and valuations show more consistent signs of stabilization, but this could take several years to materialize, given the current pace of recovery. In this process, well-located, amenity-rich Class A spaces will likely gain more appeal among investors. Meanwhile, with a gradual recovery expected over the coming years, more risk-tolerant investors trying to time the market may find the current level of elevated cap rates attractive.

Inflation and Unemployment Rate Trends



Long-Term Rates Trends



** Inflation through April, unemployment rate through May; ** Rate forecasts an average from TD, RBC, BMO, and Scotiabank*

Sources: Bank of Canada; TD; RBC; BMO; Scotiabank; Statistics Canada

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