BEYOND THE GLOBAL HEALTH CRISIS

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

National Report
Canada

Summer 2020

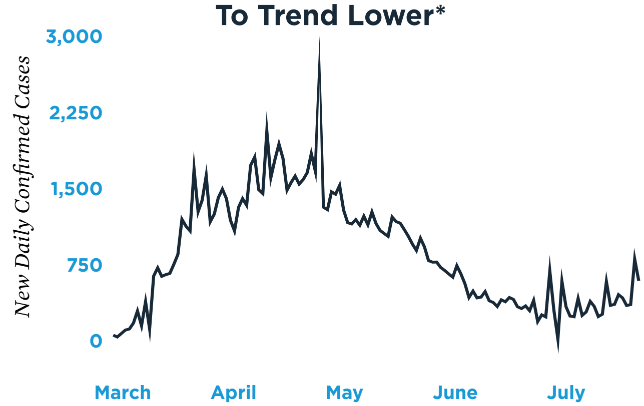
Economic Outlook Brightens as Nation Cautiously Reopens; Pandemic Accelerating Property Trends

Economy demonstrates resilience but headwinds remain. The tide started to turn for the Canadian economy in May as provincial governments announced reopening plans and establishments rehired employees. While uncertainties remain, the probability of a recovery has strengthened. As the nation advances through the health crisis, some asset classes will be more severely impacted than others, including the challenged retail sector. The virus has shifted consumer patterns and business operations, accelerating a variety of real estate trends that are creating new options for investors. The particularly strong property metrics prior to the downturn will help most markets withstand the hurdles ahead, encouraging buyers to remain active in the search for long-term growth prospects.

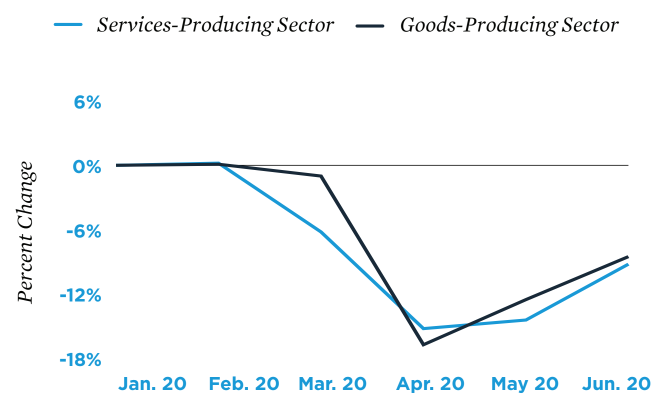
Fiscal programs supporting the economy and property markets. The government and central bank moved quickly to shore up the economy as the pandemic spread, with several measures directly impacting commercial real estate. Through the end of July, property owners can receive a rent subsidy from the Canada Emergency Commercial Rent Assistance program, helping to keep more struggling tenants in place. Retailers and other small and medium-size businesses have access to an emergency wage subsidy and interest-free loans, while those who have lost employment can receive enhanced employment insurance benefits, helping many meet rent obligations over the coming months.

Sales activity showing signs of life. Investment activity took a considerable hit in the second quarter, cutting transactions roughly by half from the prior quarter. The pace of deal flow is beginning to pick up in less impacted sectors, including multifamily and industrial, though there are headwinds. Rent collection rates have held above 90 percent for apartments, sustaining investor confidence and cash flow. The retail sector will prove to be more of a challenge with rent collections averaging below 50 percent for some owners. The financing environment is starting to loosen up as well, providing more liquidity for buyers ready to deploy capital, which will help more deals move forward as the economy reopens. Investors will naturally seek distressed assets, though the degree of government support and smaller share of at-risk assets than in the U.S. could lower defaults.

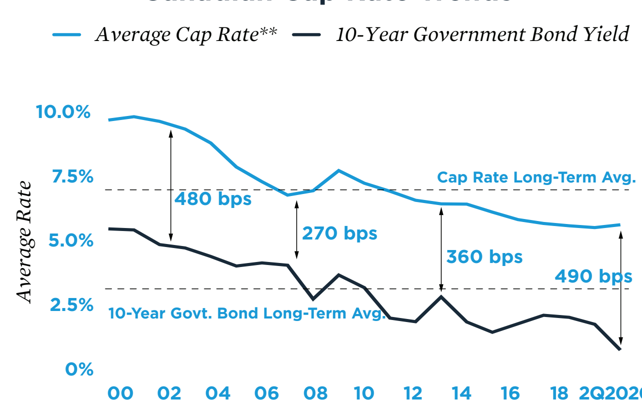
COVID-19 Cases Continue To Trend Lower*



Change in Payrolls Since January



Canadian Cap Rate Trends



*Through July 21
**Retail, office and industrial
Sources: Bank of Canada; Government of Canada; Statistics Canada; RealNet

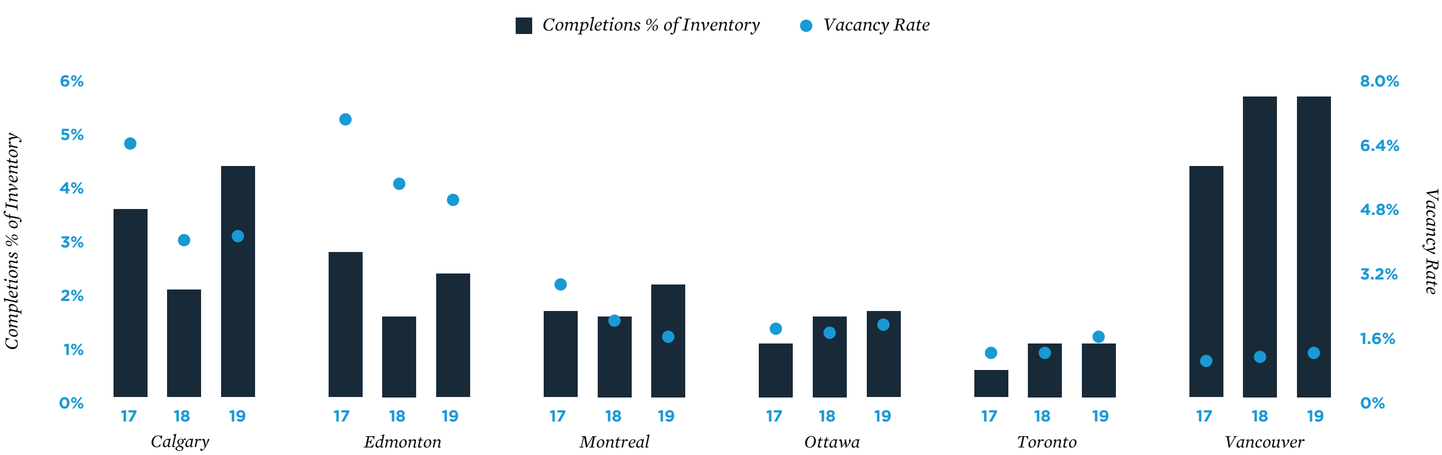
Tight Operations and Housing Shortage Bolster Apartment Market, Though Hurdles Remain on the Horizon

Immigration and diverse economy to bolster rental housing. With signs of a recovery beginning to show as the nation and provinces move to reopen the economy, the multifamily sector may prove to be a more durable asset class as long-term demand drivers remain intact. Uncertainties remain though, and the post-pandemic outcome is clouded by the possibility of a second wave of infections. Over the near term, historic unemployment and a sharp contraction in the number of immigrants admitted into the country present risks to the sector, which could push vacancy higher. Robust immigration trends have been a substantial driver of housing demand in some of the largest markets, and it will likely take an extended period to return to pre-COVID-19 immigration levels, weighing on operations through the end of the year. Markets with a robust tech, financial and government workforce could be more insulated from greater turmoil as these sectors have been less impacted. This will benefit property performance in Toronto, Montreal, Ottawa and Vancouver as many higher-paid workers have been able to adapt to a work-from-home environment more rapidly.

Eviction moratoriums, rent freeze to impact operations. Provinces and local municipalities have enacted eviction moratoriums and other measures to keep tenants in their units, creating challenges for property owners. British Columbia's temporary rental supplement was extended until the end of August, providing $500 monthly payments to landlords for tenants who have lost their jobs. A rent freeze and ban on evictions for non-payment is also in place. Rental supplements were not issued by other jurisdictions, though borrowers with CMHC-insured mortgages have access to payment deferrals. As provincial and local eviction moratoriums expire over the coming months, vacancies are likely to climb, though aid available from the Canada Emergency Response Benefit and other measures created by the federal government will assist renters facing financial hardships.

Construction stoppages to pull back supply growth. Heading into the health crisis, many markets were in a strong position to weather a downturn as vacancies sat at or near record lows. Toronto, Ottawa and Montreal recorded a rate below 2 percent at the end of last year, while Vancouver posted an exceptionally tight vacancy rate of 1.1 percent. Supply growth was estimated to push past 60,000 purpose-built rentals this year, though many projects hit pause or slowed down, extending timelines. This will help to shore up property metrics. Investment activity will slow, though, as buyers move to the sidelines and await greater clarity while the nation advances through the pandemic. Challenges to homeownership will persist, maintaining long-term growth prospects. Opportunistic buyers will remain active in the search for discounted pricing, though reductions in valuations have yet to materialize.

Apartment Supply and Demand



Source: CMHC

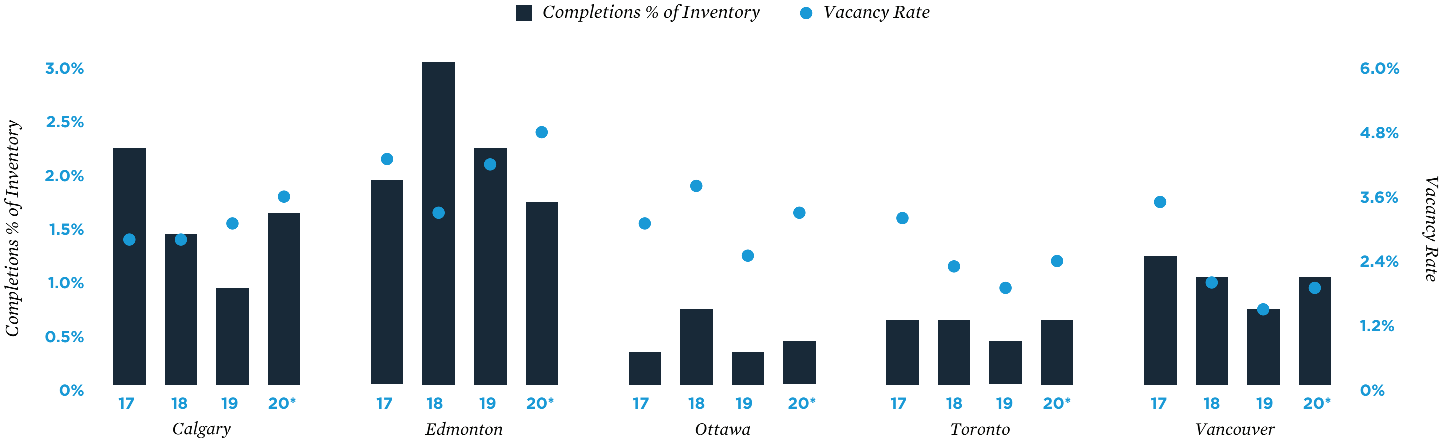
Retailers Quick to Adapt and Open New Sales Channels; Government Programs Aid Tenants and Landlords

Shift in consumer behavior drives retail evolution. The health crisis has been especially challenging for retailers as physical distancing requirements and lockdowns forced the closure of many businesses. Retail sales contracted 26.4 percent in April from March, creating uncertainty regarding whether businesses will be able to make rent payments going forward, particularly retailers with smaller cash reserves. Online sales surged 120.3 percent in April from a year ago to now account for 9.5 percent of retail trade, the highest share on record. This will encourage firms that are able to remain in business to shift their strategies and explore new sales channels, including curbside pickup options. The pandemic will leave a lasting impact on consumer behavior, favoring omnichannel and e-commerce platforms as their adoption accelerates.

Fiscal measures in place to support landlords. Most provinces have announced bans on commercial evictions as a result of the financial hardship created by the pandemic, and these extend through August. Additional measures have been introduced to support the retail sector through the Canada Emergency Commercial Rent Assistance program. Under the program, owners of property tenanted by a small business are eligible to receive a fully forgivable loan of up to 50 percent of rent, while the tenant is responsible for up to 25 percent of monthly rent. The remaining 25 percent is to be absorbed by landlords, though Quebec has announced additional aid for the province, covering half of the losses faced under CECRA. The commercial rent subsidy program was set to expire in June, but it has been extended through July. While these programs will help to shore up the sector and buoy property metrics, many retailers will not be able to withstand the hurdles ahead. Going into the health crisis, though, vacancies were exceptionally tight and remained low across most markets in the second quarter. Vancouver again registered the lowest vacancy rate in North America at 1.8 percent following a 50-basis-point increase from a year earlier, trailed by the GTA, where vacancy rested at 2.3 percent, a 30-basis-point increase. Challenges in the oil fields pushed vacancy higher in Calgary and Edmonton, to 3.5 percent and 4.7 percent, respectively.

Investment capital follows migration to the suburbs. Deliveries over the trailing 12-month period ended at midyear declined for most markets in contrast with the prior period. Supply growth was headlined by Toronto, where roughly 1.7 million square feet was completed, followed by Vancouver with an increase of 1.2 million square feet. The recent trend toward mixed-use development in more suburban areas may accelerate as a result of the pandemic as residents and companies shift their attention to areas that provide more space than the urban centre. Sales activity will also gravitate to the suburbs as buyers search for elevated yields and opportunistic deals, targeting retailers with updated business models.

Retail Supply and Demand



* Trailing 12-month period through second quarter 2020
Data unavailable for Montreal
Source: CoStar Group, Inc.

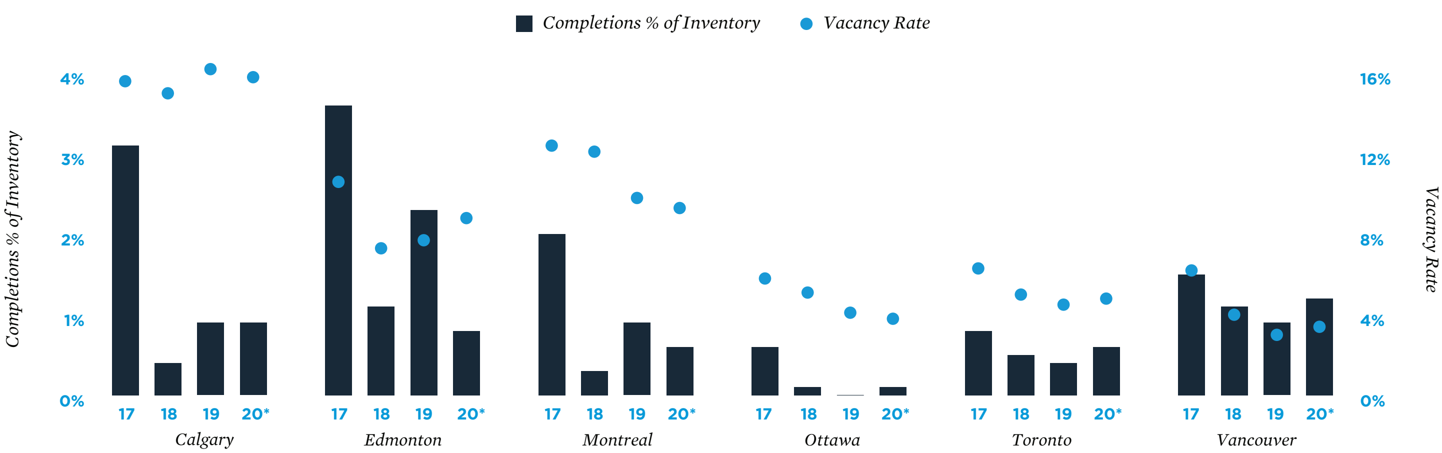
Shift to Remote Work During the Pandemic to Create Lasting Changes, Though Demand for Traditional Office Space Will Remain Sturdy

Growing interest in a work-from-home model. The transformation of Canada's digital economy over the past decade has powered the nation's office sector in recent years as major tech firms have expanded their footprints in the search for top-tier talent. As the health crisis unfolded, many office workers were able to transition to a work-from-home model, raising questions about the durability of the remote-work trend and future office demand. Some companies have announced a permanent move toward remote work, including Shopify and OpenText, though few firms will adopt that work model long term. More companies are likely to offer their employees some flexibility in working from home while still maintaining a large office presence. Over the near term, as workers start to return to the office, companies will need to manage the health risk and flatten occupancy peaks, possibly staggering the workforce or maintaining some form of remote work. Suburban offices may provide a solution by providing more space per worker, or for larger firms acting as a hub-and-spoke model to a centralized headquarters. Residential shifts to suburban markets will fuel interest in nearby office complexes as well, sustaining investor interest beyond the urban core.

Tenants putting long-term commitments on hold. More than 4 million square feet was absorbed over the year ended in June, a decline of more than 50 percent in comparison with the prior period as companies put long-term commitments on hold. Vacancy softened moderately in Toronto and Vancouver, inching up to 4.8 percent and 3.4 percent, respectively. Minimal construction in Ottawa supported a strong reduction in vacancy to 3.8 percent in the second quarter. Challenges remain on the horizon, though, as the pandemic unfolds, particularly for the hard-hit energy sector of Calgary and Edmonton, where recent supply gains are being met with softening demand. Calgary recorded the highest vacancy in the second quarter at 15.8 percent following the delivery of nearly 900,000 square feet over the past year.

Wave of new development on the horizon for the largest tech markets. More than 20 million square feet is working its way through the pipeline, headlined by Greater Toronto, where roughly 11 million square feet will be added over the next few years. Office supply is also growing considerably in Vancouver, which has approximately 7 million square feet under construction. Tech tenants and financial firms have been driving leasing activity and gravitate toward modern and updated office space, attracting investors in search of newer buildings with strong tenancy. Buyers will continue to target the tech hubs of Toronto, Vancouver, Montreal and Ottawa as many firms are unlikely to adopt a permanent work-from-home model. An attractive yield profile encourages investment beyond the urban core and to markets that face more near-term challenges such as Calgary.

Office Supply and Demand



*Trailing 12-month period through second quarter 2020
Source: CoStar Group, Inc.

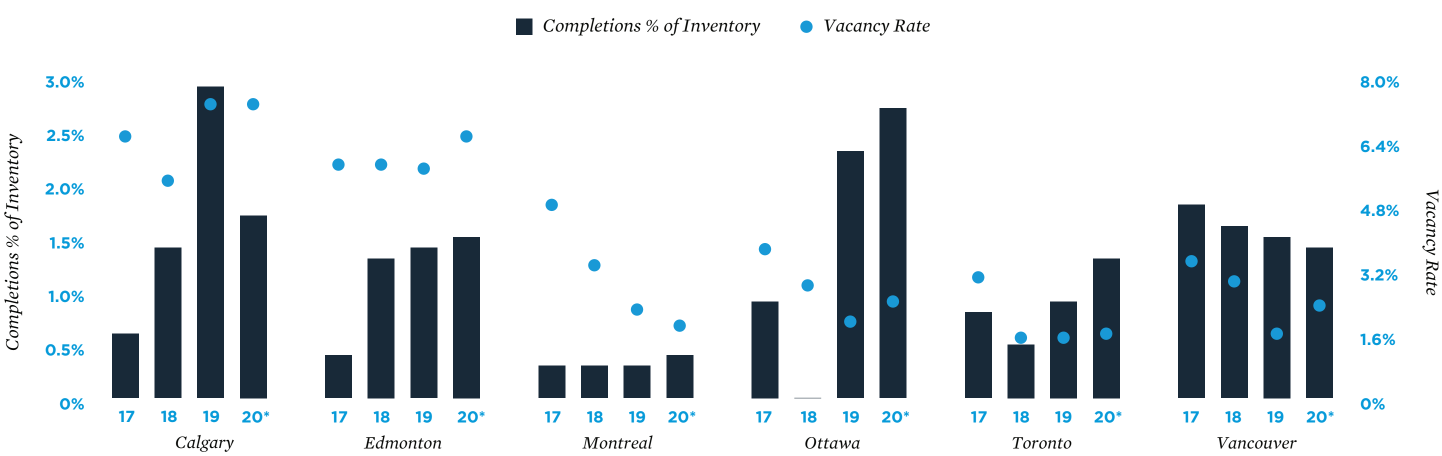
Lockdowns Push Consumers to Online Shopping at Accelerated Rate, Supporting Long-Term Demand for Industrial Space

Supply-chain disruptions may bolster space. The industrial sector has proved to be more resilient through the health crisis as shifts in consumer behavior are driving demand for distribution and logistics space, and as retailers look to gain efficiencies in their supply chains. Exceptional property metrics and growing space needs heading into the downturn will offset many hurdles, though challenges remain as weakening global demand will weigh on the manufacturing sector. Trade flows fell considerably as lockdowns took hold, contributing to an 85 percent reduction in the import of Chinese-manufactured goods through the Port of Vancouver. Manufacturers more dependent on foreign materials could shift some production back to Canada, supporting industrial demand over the long term. The United States remains the dominant trade partner, though, and as cases make a resurgence in America, it may take an extended period for some manufacturers to recover.

Evolving consumer trends altering the sector. Stay-at-home orders and the closure of many retailers have rapidly accelerated the adoption of e-commerce, driving online grocers, Amazon and other firms to continue expansion plans. Goodfood Market recently inked a deal for 200,000 square feet in the GTA to give the company its sixth fulfillment centre in the nation. Voilà by Sobeys, a new grocery delivery platform, launched its first fulfillment centre in Vaughan utilizing technology from Ocado and will occupy more space in Montreal upon completion of a second fulfillment centre. Amazon is also increasing its footprint with a second fulfillment centre in Ottawa and its fourth in Vancouver as more Canadians turn to online channels to meet their shopping needs. Nationally, more than 15 million square feet was absorbed over the past year, largely driven by distribution and logistics firms. Toronto recorded the lowest vacancy in the country in the second quarter at 1.6 percent, followed closely by Vancouver at 2.3 percent. Exceptionally tight operations have encouraged some developers to go vertical with multilevel assets, highlighting the need for industrial space.

E-commerce sustains investor sentiment. The pandemic ground many construction sites to a halt as developers were unable to obtain permits and work stoppages were put in place. As the provinces move forward with reopening the economy, work will pick back up on the more than 23 million square feet in the pipeline, though many delivery dates will be delayed. Demand will largely stay intact amid strong growth potential for distribution and logistics space, fueling some leasing competition over the next year as supply growth slows. Distribution centres with long-term leases and high-credit tenants will be highly coveted, in addition to robust demand for last-mile facilities. Vacant and obsolete retail space or malls will be of interest as these assets can be redeveloped to meet the needs of infill space near dense populations.

Industrial Supply and Demand



** Trailing 12-month period through second quarter 2020*
Source: CoStar Group, Inc.

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Price: $500

Sources: IPA Research Services; Altus Group; CMHC; CoStar Group, Inc.; Government of Canada; RealNet; Statistics Canada