Commercial Real Estate Update

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

ECONOMIC RESEARCH
economics.bmo.com

Sal Guatieri, Senior Economist
sal.guatieri@bmo.com

Like the economy, the **commercial real estate market held up better than feared at the start of the pandemic**, largely due to massive policy stimulus combined with government income, rent and loan support programs. But not all sectors fared equally well. Industrial and multi-family prospered and much of the retail sector has recovered, but offices are taking longer to regain a footing. **Continued economic growth should support commercial real estate in 2022**, limiting credit losses for lenders. However, higher interest rates will lead to slower price growth and activity, and likely some increase in office loan defaults.

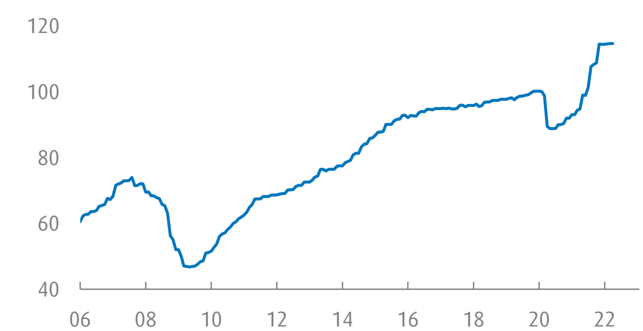
U.S. commercial **property prices** rebounded faster than expected in the pandemic (*Chart 1*). After an initial 11% slide, prices shot up 21% y/y in April 2022 and now stand 15% above pre-virus levels. The recovery was remarkably swift compared to the Great Recession, when it took nearly six years to reverse a 37% plunge in prices. Meantime, in Canada, **commercial rents** retraced earlier losses and are rising moderately, led by the industrial sector, though office and retail have also firmed.

Despite firmer loan demand, **commercial construction** continued to decline in the U.S. in 2022Q1, with real non-residential structures investment perched 22% below pre-virus levels (*Chart 2*). Office and retail construction remain weak, contrasting with strength in warehouse and factory building. Canadian builders have fared better than their U.S. peers, with nonresidential structures investment rising in 2021, though still 10% below pre-pandemic levels. Commercial construction is expected to expand moderately this year.

Credit quality remains very strong. The U.S. default rate was just 0.8% in 2021Q4, close to the lowest on record (*Chart 3*). Despite the initial pandemic shock, defaults hardly rose due to government income and rental assistance, loan forbearance programs, and the rapid economic recovery. A Fed survey shows that U.S. banks eased standards on commercial real estate loans in the three quarters to early 2022, resulting in higher origination. In Canada, business insolvencies surprisingly fell in the pandemic and remain low in early 2022. Assuming a return to more normal interest rates and slower economic growth, **default rates on CRE loans are likely to rise modestly over the next two years**.

Chart 1
Prices Pop

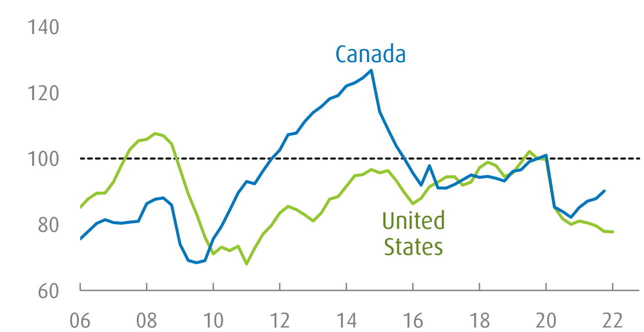
United States (Feb. 2020 = 100)
Commercial Property Price Index — All Property



Sources: BMO Economics, Haver Analytics, Green Street Advisors

Chart 2
Separate Ways

(2019 Q4 = 100)
Nonresidential Structures Investment



Sources: BMO Economics, Haver Analytics

However, landlords that have a limited ability to adjust rents in a high-inflation and slower-growth economy will struggle.

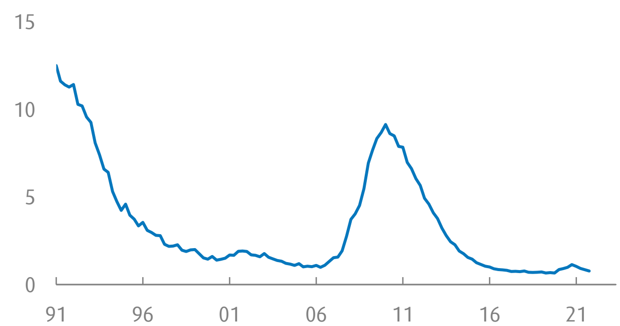
Rising interest rates will lift **capitalization rates** as investors seek higher returns, tempering future appreciation. Investor demand for commercial real estate has been strong amid broad asset-price inflation and the hunt for inflation-protected yields. Canadian cap rates held mostly steady in the pandemic, apart from the industrial sector where rates fell sharply on surging property values (*Chart 4*). Relative to long-term Government of Canada rates, the average Canadian cap rate (across all sectors) was close to long-run norms in 2021Q4, suggesting the market is fairly priced. In the U.S., strong investor demand drove cap rates sharply lower for industrial and multi-family in 2021, according to CBRE. Investment demand will soften as interest rates rise but is expected to stay healthy given that commercial properties can act as an inflation hedge.

Chart 3

Depressed Defaults

United States — All Commercial Banks (% : end-of-period : s.a.)

Commercial Real Estate Loan Delinquency Rate



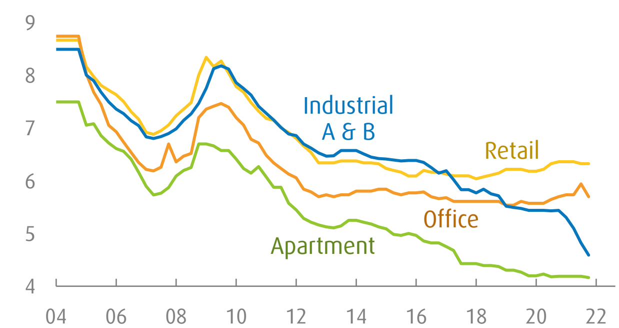
Sources: BMO Economics, Haver Analytics

Chart 4

Investors Take Note

Canada (%)

Cap Rate



Sources: BMO Economics, CBRE

Industrial

The **industrial sector thrived in the pandemic**, with higher rates of return and lower vacancy rates. Investors took note, driving property prices higher and cap rates down sharply. The sector was helped by rising demand for warehouse and fulfillment space to support e-commerce logistics, as well as demand for storage space to stock up on spare parts and materials amid transportation bottlenecks and supply-chain disruptions (first due to the pandemic, and now the war in Ukraine and lockdowns in China). Also helping was the need to expand manufacturing capacity in the face of strong goods demand and some limited reshoring of parts production (notably for microchips).

We **expect the industrial sector to keep doing well** on the back of firm business investment, although the demand for goods will slow as interest rates rise and spending shifts further toward services. A low-valued Canadian dollar against the greenback and elevated (albeit moderating) resource prices should also drive Canada's industrial sector. The main risk to the industrial outlook stems from a potential recession if monetary policy needs to tighten aggressively to control inflation.

Multi-Family Residential

The multi-family segment is enjoying solid rates of return, steady-to-lower cap rates, and low vacancy rates. The segment is supported by high house prices in both countries and, in Canada, a rebound in immigration and limited supply of purpose-built rental units. The sector has fully recovered after facing lower rents and higher vacancies in the early days of the pandemic after immigration plunged, students switched to online classes, and teleworkers fled from downtown offices. Investors see the sector as a partial hedge against inflation with higher wages supporting rents, and Canada's apartment cap rate (4.2% in 2021Q4) is now the lowest since at least 2004.

Rising interest rates will drive a much-needed cooldown in the housing market, returning sales to more normal levels and reining in rampant appreciation. Cushioning the decline will be rising immigration (in Canada), continued demand from millennials, and low unemployment. A welcomed rebalancing will likely see Canadian house prices retrace a portion of the past year's record gain, while U.S. prices should level out later this year. We are not expecting a deep, sustained correction in Canadian house prices given underlying support from immigration, low inventories, and an outlook for interest rates to merely return to neutral levels. Demand for apartments is likely to stay strong in the face of limited affordability in many cities. However, **Canada's market is at greater risk of a correction than the U.S. market** due to higher prices and weaker affordability (some exceptions are the Prairie Provinces and Newfoundland & Labrador) This risk will increase if interest rates rise much more than anticipated. In this event, lower home values would also depress apartment building values.

Retail

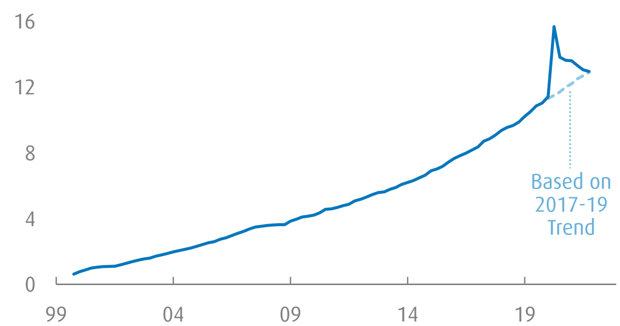
After struggling with several rounds of restrictions to control the pandemic, the **retail sector is making a decent comeback**. U.S. rates of return turned higher after falling in 2020 and early 2021. The segment is supported by healthy consumer demand and high household savings, as well as a notable pivot back to in-person shopping. In the U.S., available retail space fell to a 10-year low in 2021Q4, according to CBRE, amid rising demand and falling supply. Easing pandemic restrictions allowed Canada's retail sector to enjoy relatively stable cap and vacancy rates (albeit higher in Calgary) and moderate rent growth of 3.8% y/y in 2021Q4, according to Statistics Canada. The number of active retail businesses recently surpassed pre-pandemic levels. While sales will slow in response to higher interest rates, we **expect the retail sector to expand as households deploy excess savings** amounting to over 13% of disposable income in both countries. Retail vacancy rates are expected to fall, which will help landlords as the last of Canada's pandemic-support programs (targeted at the tourism and hospitality sectors) expired on May 7.

Concern that the pandemic might drive a permanent shift toward online shopping seems unfounded. E-commerce accounted for 13.0% of U.S. retail sales (excluding food services) in 2021Q4, up from 11.0% in 2019Q4 but off earlier highs and in line with pre-pandemic trends (*Chart 5*). Shopping habits don't appear to have changed much, as customers eagerly returned to physical stores when restrictions were lifted.

Chart 5
Reversion To Trend

United States (%)

Retail E-commerce as a % of Total Retail (ex. Food Services)

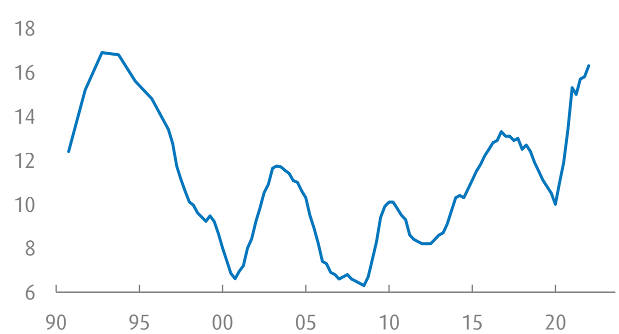


Sources: BMO Economics, Haver Analytics

Chart 6
Ample Office Space

Canada (%)

Office Vacancy Rate — All Classes



Sources: BMO Economics, CBRE

Some retailers face bigger challenges than others, including those without an omni-channel approach for customers who prefer both online and in-store experiences. Successful retailers are also using physical stores to facilitate e-commerce orders and returns. Successful malls are providing enhanced social experiences. Small, enclosed malls in smaller markets with limited redevelopment potential are at greater risk. **Stores that primarily serve office workers face a shrunken market**, as even a small change in the commuter crowd has a large adverse effect on revenues given the concentrated nature of this demand. In the same vein, business travel is unlikely to return to pre-pandemic levels as companies strive to cut costs and carbon footprints via more virtual meetings.

Office

The **office sector is returning to life as restrictions ease, but to a very different life than before the pandemic** due to the widespread adoption of remote working. Despite rising vacancy rates, loan defaults have stayed low due to government support programs and lengthy leases.

In **Canada**, the sector is seeing surprisingly **steady cap rates and higher rents**. While demand has dropped off, so too has new construction. Still, the national office vacancy rate of 16.3% in 2022Q1 is up 1 ppt from a year ago and 6 ppts from before the pandemic (*Chart 6*). Sublease activity is high across the country, and net absorptions were negative in 2021Q3. Accordingly, office rents across 13 metro regions are up a modest 1.8% y/y in 2021Q4, finds Statistics Canada. U.S. office buildings are **seeing a small rate of return** after slipping in early 2020.

More than two years after the pandemic began, **we still don't have much clarity on the long-term outlook for office demand**. Based on unique user card swipes compiled by Kastle System, 43% of office space in 10 large cities was occupied as of early May (relative to pre-pandemic levels). This is up from 31% last August and from 38% in early March, but the rate of improvement has slowed, with still a large amount of unused space to fill. Some workers still worry about health concerns due to the pandemic. But more to the point, **surveys suggest workers generally prefer to spend more time at home than in the office**. At least half of office workers want a hybrid approach, and more workers wish to work from home full-time rather than in the office each day. A survey of Canadian office workers (Amazon Business Return to Office Report) found that 43% would likely seek another job if asked to return to the office full-time. The longer people work mainly from home, the more likely they are to adjust their lifestyle around remote working. Most firms, in fact 87% according to CBRE's 2021 Occupier Sentiment Survey, are expected to adopt a hybrid approach. In a tight labour market, many companies will need to provide flexible work arrangements to stay competitive. **Companies are trying to figure out the right balance** that maximizes the employee's desire for flexibility and commuter savings, and still satisfies the company's need for in-person collaboration to enhance corporate culture and creativity. Some firms are waiting for leases to expire before making a final decision (though not tech giant Google, which is expanding its office footprint in California and London despite offering a flexible work approach). **Offices will likely remain integral to workplace engagement**. Even if most workers don't go into the office five days a week, the demand for office space is unlikely to shrink commensurately, as more space will be used for common areas to enhance work experience. Assuming employees eventually spend an average of about 60% of their work time in the office, we continue to **expect demand for office space to decline 10%-to-20% from pre-pandemic levels**.

The **main long-term risk to the office segment stems from a greater adoption of remote work**. In this event, new Class A towers are likely to outperform older buildings that are ill-suited for information technologies and enhanced experiences. Unused office space (at least in newer, environmentally friendly buildings) will need to be repurposed for living and warehouse needs. In fact, last year a record number of U.S. office buildings were converted to apartments. Buildings with more windows than cement have an advantage here. Repurposing and repricing of office space will limit credit losses of office owners and lenders, though vacancy rates could stay high for a while given the lengthy time to convert buildings. As well, conversions can be difficult in some municipalities given zoning restrictions, which will make it harder to recoup loan losses. In addition, the office sector will be more vulnerable in regions with weak population trends.

Bottom Line: Repricing and repurposing of space will help the office sector navigate challenges posed by a semi-permanent shift toward remote working. The biggest immediate challenge for all sectors, including thriving industrial and multi-family, stems from rising interest rates to corral inflation, which risks sending the expansion into reverse. A recession would drive rents and property values lower, resulting in lower loan demand and higher default rates.

General Disclosures

BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A. (member FDIC), Bank of Montreal Europe p.l.c, and Bank of Montreal (China) Co. Ltd, the institutional broker dealer business of BMO Capital Markets Corp. (Member FINRA and SIPC) and the agency broker dealer business of Clearpool Execution Services, LLC (Member FINRA and SIPC) in the U.S., and the institutional broker dealer businesses of BMO Nesbitt Burns Inc. (Member Investment Industry Regulatory Organization of Canada and Member Canadian Investor Protection Fund) in Canada and Asia, Bank of Montreal Europe p.l.c. (authorised and regulated by the Central Bank of Ireland) in Europe and BMO Capital Markets Limited (authorised and regulated by the Financial Conduct Authority) in the UK and Australia. BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such Information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Economic Publications: Our publications are disseminated via email and may also be available via our web site https://economics.bmo.com. Please contact your BMO Financial Group Representative for more information.

Additional Matters

This report is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Its contents have not been reviewed by any regulatory authority. BMO Capital Markets does not represent that this report may be lawfully distributed or that any financial products may be lawfully offered or dealt with, in compliance with regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder.

To Australian residents: BMO Capital Markets Limited and Bank of Montreal are exempt from the requirement to hold an Australian financial services licence under the Corporations Act in respect of financial services they provide to wholesale investors (as defined in the Corporations Act). BMO Capital Markets Limited is regulated by the UK Financial Conduct Authority under UK laws, and Bank of Montreal in Hong Kong is regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission which differ from Australian laws. This document is only intended for wholesale clients (as defined in the Corporations Act 2001),Eligible Counterparties or Professional Clients (as defined in Annex II to MiFID II) and Professional Investors (as defined in the Securities and Futures Ordinance and the Securities and Futures (Professional Investor) Rules under the Securities and Futures Ordinance of Hong Kong).

To Canadian Residents: BMO Nesbitt Burns Inc. furnishes this report to Canadian residents and accepts responsibility for the contents herein subject to the terms set out above. Any Canadian person wishing to effect transactions in any of the securities included in this report should do so through BMO Nesbitt Burns Inc.

To E.U. Residents: In an E.U. Member State this document is issued and distributed by Bank of Montreal Europe plc which is authorised and regulated in Ireland and operates in the E.U. on a passported basis. This document is only intended for Eligible Counterparties or Professional Clients, as defined in Annex II to "Markets in Financial Instruments Directive" 2014/65/EU ("MiFID II").

To U.K. Residents: In the UK this document is published by BMO Capital Markets Limited which is authorised and regulated by the Financial Conduct Authority. The contents hereof are intended solely for the use of, and may only be issued or passed on to, (I) persons who have professional experience in matters relating to investments falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (II) high net worth entities falling within Article 49(2)(a) to (d) of the Order (all such persons together referred to as "relevant persons"). The contents hereof are not intended for the use of and may not be issued or passed on to retail clients.

To Hong Kong Residents: In Hong Kong, this report is published and distributed by Bank of Montreal. Bank of Montreal (incorporated in Canada with limited liability) is an authorized institution under the Banking Ordinance and a registered institution with the Securities and Futures Commission (CE No. AAK809) to carry on Type 1 (dealing in securities) and Type 4 (advising in securities) regulated activities under the Securities and Futures Ordinance (Cap 571 of the Laws of Hong Kong). This report has not been reviewed or approved by any regulatory authority in Hong Kong. Accordingly this report must not be issued, circulated or distributed in Hong Kong other than (a) to professional investors as defined in the Securities and Futures Ordinance and the Securities and Futures (Professional Investor) Rules under the Securities and Futures Ordinance of Hong Kong, or (b) in circumstances which do not result in or constitute an offer to the public in Hong Kong.

To Israeli residents: BMO Capital Markets is not licensed under the Israeli Law for the Regulation of Investment Advice, Investment Marketing and Portfolio Management of 1995 (the "Advice Law") nor does it carry insurance as required thereunder. This document is to be distributed solely to persons that are qualified clients (as defined under the Advice Law) and qualified investors under the Israeli Securities Law of 1968. This document represents the analysis of the analyst but there is no assurance that any assumption or estimation will materialize.

To Korean Residents: This report has been provided to you without charge for your convenience only. All information contained in this report is factual information and does not reflect any opinion or judgement of BMO Capital Markets. The information contained in this report should not be construed as offer, marketing, solicitation or investment advice with respect to financial investment products in this report.

To Japan Residents: This report has not been reviewed by any regulatory authority in Japan. This report is provided for information purposes only and it should not be construed as an offer to sell, a solicitation to buy, or a recommendation for any security, or as an offer to provide investment management or advisory or other services in Japan. Securities may not be offered or sold in Japan by means of this report or any other document other than to Qualified Financial Institutions within the meaning of item (i) of Article 17-3 of the Government Ordinance to enforce the Financial Instruments and Exchange Act (Kinyu Shohin Torihiki Ho Sekou Rei). Unless specified otherwise, the securities that may be offered to you are not and will not be registered in Japan pursuant to the Financial Instruments and Exchange Acts.

To Taiwanese Residents: This report is not intended to constitute investment advice nor a public offer for any investment products to investors in Taiwan. This report should only be accessed by investors in Taiwan that are qualified to invest in investment products pursuant to relevant Taiwanese laws and regulations, and subject to sales restrictions as set forth in the relevant Taiwanese laws and regulations. BMO Capital Markets has not and will not secure the required licenses in Taiwan for the offer of securities and investment services. Any offer of securities has not been and will not be registered or filed with or approved by the Financial Commission of Taiwan and/or other regulatory authority pursuant to relevant securities laws and regulations of Taiwan, and may not be issued, offered or sold within Taiwan through a public offering or in circumstances which constitute an offer that requires a registration, filing or approval of the Financial Supervisory Commission of Taiwan and/or other regulatory authority in Taiwan under relevant securities laws and regulations of Taiwan. No person or entity in Taiwan has been authorized to offer or sell the securities in Taiwan.

To PRC Residents: This material does not constitute an offer to sell or the solicitation of an offer to buy any financial products in the People's Republic of China (excluding Hong Kong, Macau and Taiwan, the "PRC"). BMO and its affiliates do not represent that this material may be lawfully distributed, or that any financial products may be lawfully offered, in compliance with any applicable registration or other requirements in the PRC, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. This material may not be distributed or published in the PRC, except under circumstances that will result in compliance with any applicable laws and regulations.

To Singapore Residents: This report is intended for general circulation and does not and is not intended to constitute the provision of financial advisory services, whether directly or indirectly, to persons in Singapore. You should seek advice from a financial adviser regarding the suitability of the investment products, taking into account your specific investment objectives, financial situation or particular needs before you make a commitment to purchase the investment product. This report has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, it should not be circulated or distributed, nor may the securities described herein be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (a) to an institutional investor or a relevant person as defined in and pursuant to and in accordance with the conditions of the relevant provisions of the Securities and Futures Act of Singapore or (b) otherwise pursuant to and in accordance with the conditions of, any other applicable provision of the SFA.

To Thai Residents: The contents hereof are intended solely for the use of persons qualified as Institutional Investors according to Notification of the Securities and Exchange Commission No. GorKor. 11/2547 Re: Characteristics of Advice which are not deemed as Conducting Derivatives Advisory Services dated 23 January 2004 (as amended). BMO and its affiliates do not represent that the material may be lawfully distributed, or that any financial products may be lawfully offered, in compliance with any regulatory requirements in Thailand, or pursuant to an exemption available under any applicable laws and regulations.

To U.S. Residents: BMO Capital Markets Corp. furnishes this report to U.S. residents and accepts responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal.

These documents are provided to you on the express understanding that they must be held in complete confidence and not republished, retransmitted, distributed, disclosed, or otherwise made available, in whole or in part, directly or indirectly, in hard or soft copy, through any means, to any person, except with the prior written consent of BMO Capital Markets.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., (Member FDIC). Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets.