# Commercial Real Estate fall 2021 industry update

As the world approaches the end of year two of the COVID-19 pandemic, Canada's commercial real estate markets appear to be weathering the storm well. Similar to what we saw during the global financial crisis in 2008, the initial shock of the pandemic in early 2020 saw CRE market activity all but freeze as lenders and investors entered crisis mode.

Pens went down and attention turned to portfolio management, work-from-home logistics and deployment of government relief programs. However, a better understanding of the pandemic along with rising vaccination rates has led to optimism quickly returning to CRE markets.

With light at the end of the COVID-19 tunnel and improving property level fundamentals, sentiment toward Canadian CRE is generally positive. Investment activity is strong—amazingly enough, currently on track for its most active year on record. Lenders have returned in force, and there is abundant debt available for CRE investors and developers, albeit with heightened selectivity for assets more susceptible to adverse pandemic-related impacts.

So, what does all this mean for borrowers? Mostly good news. With business confidence retuning and the economy poised for rebound, virtually all CRE lenders are back to lending—some with a vengeance to make up for lost loan production during 2020. Liquidity among lenders is high, which has driven credit spreads below pre-pandemic levels for most asset classes.

Industrial and multifamily properties are most in favour with lenders. Credit spreads on these "beds and sheds" are approaching historic lows, occasionally touching 125 bps over five-year Government of Canada bonds for top-tier assets in major markets. High liquidity for insured multifamily mortgages has CMHC pricing likewise near historic lows for borrowers willing to wait 14 to 20 weeks for their insurance applications to be processed.

Lenders have warmed to necessities-based retail, ideally with food or drug anchor tenants. However, retail properties with heightened exposure to e-commerce, social distancing requirements or discretionary goods like fashion remain more challenging to finance.

A foggy outlook on the office sector means lender appetite is patchy at best, particularly for lower quality or suburban properties, which are expected to underperform while the dust settles on the emerging work-from-home economy.

Geographically, Alberta has been low on many lenders' dance cards for several years, as the province has struggled with low resource prices. However, energy's recent rally could see that negative sentiment start to improve soon.

Finally, on the economic front it's all eyes on inflation, which could see mortgage coupons rise with interest rates and a corresponding reduction in the leverage capacity for properties with long-term leases unable to keep pace with CPI.

As Canada emerges from the late stages of the pandemic, we take a look at the key themes that are trending across CRE's four primary segments, or "food groups":

- Office
- Industrial
- Retail
- Multifamily

## Office

Office is the most discussed segment in commercial real estate. The pandemic forced the majority of Canadian office workers to pivot to working from home. Home offices were set up, new routines established, collaborative video tools embraced and billions spent to provide new IT infrastructure for working remotely. Tech research firm Gartner forecasts global IT spending related to remote work to total more than C$400 billion spent globally in 2021.[1]

With pandemic pressures now easing, many workers are eagerly returning to the office to reconnect with colleagues and rebuild relationship capital. Few, however, see themselves returning to their pre-pandemic Monday through Friday office routine. Millennials and Gen Z workers value flexibility—often more than compensation—and are indicating a strong preference for a hybrid office-remote work model.

A 2019 study by the International Workplace Group found that 80% of workers would turn down a job that did not offer a flexible work schedule.[2] Welcome to Gen Flex! The pandemic proved definitively that working from home can, well, work. With the genie out of the bottle, the burning question for commercial real estate remains: what does this mean for Canada's office market?

The honest answer is that no one really knows. Ask 10 experts and you'll get 10 different opinions. One commonly mentioned figure is a 10% to 20% reduction in demand for office space long term. What that means for vacancy, and ultimately rental rates, is less clear. CBRE reports Canada's national office vacancy is currently 15.7%, its highest since 1994. Admittedly, that sounds scary, but there is encouraging news. CBRE also reports declining sublease vacancy, increasing leasing activity and positive absorption in many of Canada's major markets.

These green shoots suggest the worst for office could be behind us. Should high vacancy persist, expect new office construction to be postponed for a few years until the supply-demand balance is restored. Office is not dead, but office construction likely is for a while. Although no one is predicting anything as dramatic as the illustrious six-storey concrete "stump" which lingered in downtown Toronto for 15 years after construction of an office building was halted in 1991 during a recession. At this point, a relatively soft landing for office appears more likely.

**BOTTOM LINE:** The current uncertain outlook on office has curbed the enthusiasm of many lenders to finance this segment as they wait for clarity around the impact of remote working on office demand. BMO recognizes that the office landscape is evolving, but we believe the office will continue to be the centre of gravity for most businesses, and we remain committed to financing in the office sector—albeit with heightened selectivity compared with the pre-pandemic days.

[1] Gartner [2] International Workplace Group

## Industrial

The industrial segment has been the clear winner through COVID-19. Retail's pain is industrial's gain, and e-commerce is blurring the line between retail and industrial. The growing need for logistics and fulfillment centres has ushered in a boom across the entire industrial sector.

Industrial vacancy is near record lows across Canada, with Toronto, Vancouver, Montreal and Ottawa below 2%—among the tightest industrial markets North America. Low availability has industrial rents on the rise, fast approaching retail rents for logistics space within the all-important "last mile" of consumers.

Any relief provided by the approximately 20 million square feet of new industrial space expected to be completed by the end of 2021 is likely to be short-lived, given that 75% of it is already pre-leased. The reality of land constraint in the major markets—Toronto and Vancouver in particular—has developers now thinking vertically.

Key industrial trends to watch include higher ceilings, multistory properties, conversion of big-box retail to industrial and the use of volume metrics such as cubic meters as opposed to traditional square footage metrics.

**BOTTOM LINE:** We're running out of superlatives to describe the strength of Canada's industrial commercial real estate market. Lenders have piled onto the bandwagon, and competition among lenders for industrial deals is driving credit spreads to historic lows. BMO's appetite for financing industrial properties is similarly strong. With downward pressure on industrial mortgage pricing, most banks find themselves more competitive on "core-plus" properties—those in transition or in secondary locations—than trophy "core" properties, which are increasingly gravitating to the lower pricing of Lifeco commercial mortgage lenders.

## Retail

The retail segment has been the clear loser through COVID-19. The pandemic accelerated evolving consumer behaviour patterns already in motion. Lockdowns and social distancing forced consumers to embrace e-commerce and saw the number of retailers with an e-commerce platform double to almost 60%.[1]

The economy is now poised for recovery, and BMO Economics observes that the industries yet to recover represent only 4% of GDP. However, these hardest-hit industries include sectors with a high physical footprint, such as clothing and accessories, food services and entertainment, which will continue to pose headwinds for retail commercial real estate until the end of social distancing permits their full recovery.

Grocery and drug-anchored "necessities" retail performed well through the pandemic and remain very much in favour. However, properties catering to discretionary goods, like housewares and fashion, are struggling to attract investors or lenders. The same goes for enclosed properties in smaller markets with limited alternative use or redevelopment potential. These trends will likely see Canada's overall retail footprint contract as weaker properties on "good dirt" are repurposed, such as Amazon's recent purchase of Woodbine Mall and Fantasy Fair, which boasts 22 acres of highly strategic land in Toronto.

Canada's retail landscape is continually evolving. What emerges from this latest evolution is certain to be more convenient, outdoor accessible, digitally integrated and ultimately stronger.

**BOTTOM LINE:** Retail has performed better than most expected at the outset of the pandemic. While the sector remains under intense scrutiny, its apparent resilience has seen many lenders ease back to the table, including BMO, although we're not placing any big bets just yet. BMO's current appetite for retail could best be described as moderate but increasing. A yellow light to proceed with caution, with a bias toward properties with a mix of necessities-based and essential services tenants.

[1] Colliers

## Multifamily

The multifamily segment performed extremely well through the pandemic. Fundamentals briefly weakened across the board in 2020 with vacancy up and rents down as immigration declined, household formation slowed, students returned home for online study and young office workers doubled-up with roommates or moved back in with parents to save money. However, this initial softening appears to have been short-lived.

The return of on-campus learning has more domestic and foreign students signing leases, while the reopening economy has workers returning to the rental market. This demand rebound has market fundamentals effectively back to pre-pandemic levels, with bidding wars resuming for the downtown apartments so coveted by young professionals. Increased Canadian immigration targets to make up for lost ground will soon see an influx of new immigrants, which is certain to further bolster rental demand.

Shaun Hildebrand, president of multifamily market research firm Urbanation, captured these trends well in his comments to *The Globe and Mail:* "The [urban] exodus story is completely overblown. Now that things are reopening again, everybody's coming back."

Quite.

**BOTTOM LINE:** Lenders love multifamily. With low vacancy, limited new supply and rents that adjust quickly to inflation, what's not to love? BMO shares the amour. Multifamily is the largest asset class in BMO's commercial real estate debt portfolio, and we maintain a high appetite to finance multifamily properties.

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