Commercial Real Estate Winter 2024 market update

Bricks, clicks and the pace of change

Commercial real estate has historically been considered a quiet industry. Some even called it boring. Change happened, but slowly, almost imperceptibly. Cycles were long, driven mostly by local forces that were fairly predictable and could be seen on the horizon, giving the market plenty of time to adapt to the glacial pace of change in human behaviour.

The commercial real estate (CRE) industry of today is increasingly impacted by events and structural changes versus the mere cyclicality it experienced in the past. Today's successful CRE operators are defined by how quickly they can "pivot." Environmental, social and governance (ESG) initiatives are rapidly enveloping the real estate industry, with considerations around climate risk, environmental impact and societal welfare factoring alongside economic benefit, introducing additional complexity to real estate decisions. Technology, in particular, has accelerated both the pace and frequency of change, bringing new consumer behaviours, geopolitical events and disruptive technologies to the forefront. Human behaviour is simply changing more rapidly than ever, and real estate has to run faster to keep up or be left behind.

In our Winter 2024 Market Update, we examine some of the changes taking place in the industry landscape, the opportunities they may present, and the growing importance of change management skills among today's CRE professionals in order to navigate the industry's increasing volatility.

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Capital

The COVID-19 pandemic sparked economic changes at a pace few have seen in living memory. The initial monetary response delivered extremely low interest rates and excess liquidity as governments sought to stimulate economies. That policy pendulum quickly swung to rapid interest rate increases to combat the ensuing inflation, and reduced capital availability as governments sought to bolster the global banking system.

As a capital-intensive asset class, CRE is impacted by the cost and availability of capital. Since late 2019, the cost of mortgage debt as gauged by the Canadian 10-year government bond yield has increased approximately 200 basis points, and almost 400 bps from trough to peak. That's a lot of interest rate volatility for the market to absorb in 48 months. Cap rates, meanwhile, have increased on average only a corresponding 80 bps—mostly for office and retail properties, while industrial and multifamily cap rates have barely budged1 due to their strong fundamentals, high investor demand and tight supply.

With relatively little CRE currently trading in the market, it's challenging to gauge the precise impact of today's higher interest rates on cap rates beyond directional momentum. As cap rates typically follow Canadian bond yields to provide investors with an adequate risk-adjusted return over risk-free investments, the fact

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that cap rates are currently believed to be hovering approximately 242 bps over bonds versus their historic average of approximately 345 bps[1] suggests investors are betting interest rates will decline once the Bank of Canada has beaten inflation back to its target of 2% over the next year or two, as is widely expected. This anticipation of more favourable borrowing conditions on the horizon helps explain 2023's reduced CRE investment activity, which CBRE currently forecasts to decline 23% in Canada and 44% globally compared to 2022.[2]

Capital availability is also in flux. The increasing regulatory requirements for banks to hold more capital against CRE loans (which we discussed in our Spring 2023 CRE Market Update) are taking hold.[3] The impact of these changes is that there is currently less CRE debt capital available than in the past. Canadian banks are superb managers of capital and are responding with innovative new means of capital management, including risk transfer solutions such as synthetic loan securitization, which BMO was the first Canadian bank to pioneer in 2021, and BMO Global Asset Management's forthcoming CRE Credit Fund which will offer investors an opportunity to co-invest with the Bank in BMO's CRE loans, a structure which may be a global first.

Higher capital requirements have also intensified banks' need to grow their customer deposits. Deposits are the primary fuel for bank lending engines. To keep those fireboxes stocked, banks are now equally focused on growing deposits as loans within their lending relationships.

The pricing of CRE loans is another item to watch. Banks calibrate loan pricing to ensure an acceptable return to the bank on the capital that bank regulators require them to hold for each individual loan. Higher capital requirements require higher pricing to attain the same return on capital, which ultimately means higher credit spreads. While we have yet to see a meaningful increase in CRE credit spreads in Canada's highly competitive lending market, expect to see them start to creep up through 2024. Also expect to see new alternative lenders with more transactional business models, such as mortgage funds and commercial mortgage-backed securities (CMBS) lenders, enter the market to fill this capital gap with higher-priced loan products, allowing banks to focus their scarcer capital on more relationship-oriented balance sheet loans funded with deposits.

Office

Office remains the asset class of the greatest near-term concern and focus. The trend towards remote work was arguably an inevitable evolution of the office market that began when the first mobile phones and laptop computers emerged in the 1980s. The pandemic's lockdowns forced the world to quickly develop and embrace tools to enable work from anywhere in the world, accelerating a trend that might otherwise have unfolded over decades into just 24 months and catching the office market unprepared.

With some degree of remote work apparently here to stay, the office market now finds itself weathering an unexpected storm. Vacancy has spiked, new construction has all but halted and investor appetite for office properties has all but evaporated.

Lender appetite for office has likewise receded. A recent CBRE survey of 34 lenders (including BMO) found that while overall lender sentiment toward real estate improved year-over-year, and that 94% intend to maintain or increase their real estate lending in 2024, 93% expect elevated or significantly elevated credit risk in office renewals and refinancings in 2024, with 67% intending to reduce and none planning to increase their allocation to office in 2024.[4] Against those headwinds, borrowers can expect an effective freeze on new office debt in 2024 from all but the most aggressive of lenders, as well as some potentially challenging discussions with their current lenders around renewal of their existing office loans.

The office market's stress is perhaps most evident in vacancy. Similar to the U.S., Canada's national office vacancy has risen from approximately 10% pre-pandemic to 18% today – levels not seen since the overbuilding-induced office correction of the early 1990s.[5,6] Back then, however, the downturn was more widespread, with rents virtually collapsing across all office asset classes. The current office correction is different in that tenant demand and market rents remain reasonably healthy for high-quality buildings offering the location, amenities and configurations necessary to attract workers back to the office, while tenant demand for inferior, low-cost, commoditized office space has effectively evaporated.

Canada's office market, however, does differ favourably from the U.S. in that much of Canada's Class A inventory is owned by deep-pocketed financial institutions with long-term investment horizons and the patience to weather cycles, gradually improve rent rolls, and redevelop or convert their office properties over time. While the U.S. office market is dominated by more opportunistic private equity investors with shorter investment durations and who are more inclined to cut bait and sell assets at a loss when markets turn against them, Canada's more patient institutional capital enables its office market to behave with greater stability in times of downturn and excess inventory.

While Canada certainly now has more office space than it needs, there is growing sentiment that the market is not so much overbuilt as under-demolished. Conversion of obsolete buildings to more viable uses will be a key trend emerging from this cycle and a chance for creative developers able to embrace the opportunities these rapid changes present. Together with a pause in new construction and positive absorption from long-term economic growth, office conversion should help gradually restore balance and confidence to the office market, with a timeline for a return to "normal" of at least five years.

Industrial

Accelerated change has likewise enveloped the industrial market. With benign images of nondescript warehouses, smokestacks, rail spurs and piles of material rusting in the back lot, few asset classes have attracted as little attention over the years as industrial real estate. Investors were attracted to its long-term leases and low complexity. But with rents hovering seemingly forever in the $3 to $6 per square foot range with little upside in sight, industrial kept a pretty low profile.

Until the pandemic that is.

The pandemic sparked rapid acceleration of preexisting e-commerce trends as housebound consumers were forced to embrace online shopping, and everything changed for industrial. Retail inventory migrated from stockrooms to fulfilment centres, increasing demand for industrial space. The logistics industry exploded, industrial vacancy plummeted and national average asking rents rocketed to their current historic high of over $16 per square foot[7] and $25 per square foot for prime buildings.[8]

While that dizzying rental rate growth is now levelling off and most of the early gains have been harvested, the outlook for industrial remains strong. New supply is slowly catching up to tenant demand, but the realities of land constraints along key transportation corridors and within the all-important "last mile" to consumers ensure the market will remain tight. Those strong fundamentals have moved industrial to the top of every CRE investor's and lender's wish list, creating fierce competition for industrial acquisitions and loans.

Fortunately, Canadian investors have a fairly accurate crystal ball in the form of the U.S., where CRE markets tend to be three to five years ahead of Canada. Emerging industrial trends in the U.S. such as industrial outside storage (IOS) and multilevel industrial buildings could present early-mover opportunities for Canadian CRE investors looking for upside. In the longer term, astute investors should monitor the potentially disruptive technology of driverless trucks, which could impact industrial real estate by deemphasizing the importance of industrial properties' proximity to consumers and truck drivers.

Retail

At the outset of the pandemic retail was the area of greatest concern, with lockdowns and social distancing propelling retail to the top of the CRE watch list. Now just a few years later retail is back in favour. In particular, necessities-oriented retail focused on daily needs (groceries, pharmaceuticals, services—essentially anything you need in a hurry or can't buy online) is currently one of the three most favoured asset classes among investors and is now worth more than it was before the pandemic.

Of course, change is the name of the game in retail. With retail consumer behaviour changing faster than ever, successful retailers know that change is just another word for survival.

E-commerce has amplified the magnitude and pace of that change, bringing increased volatility to the retail CRE sector. Retail is now all about bricks and clicks, with an omnichannel retail distribution strategy now essential to survival. In this new environment, management must be progressive and nimble, even radical—able to leverage emerging technology like AI to manage inventory, embrace the latest consumer trends such as pop-up stores, and harness innovative scarcity marketing tactics like "limited quantities" and "sold out" to generate buying urgency among consumers.

Retail properties must likewise now continually reinvent themselves in step with these new-age tenants, using such tactics as:

- Replacing tired food courts and defunct department store anchors with more experiential uses and tenants
- De-malling for greater shopping convenience and operational efficiency
- Rethinking traditionally less-desirable tenants like yoga studios, which could bring desirable foot traffic to the property
- Continually adjusting their tenant mix to appeal to fickle consumers' ever-changing preferences

Retail consumers' financial health is also continually changing. Canada's high household debt levels could impact retail sales should the economy falter, injecting potential additional volatility into the retail cocktail. For retailers, this means continually adjusting their product offering to avoid carrying unsold inventory. For retail properties, it means carefully managing their tenant mix to ensure the best chance of attracting retail traffic.

Multifamily

Apartment buildings are another asset class that have seen little change over the years. With negligible new construction since the 1970s, low vacancy, stable rents and the reliable availability of CMHC financing, there has historically been minimal change in this long-term buy-and-hold sector.

But increased housing demand, driven by population growth and higher immigration targets, has pushed the cost of home ownership to the breaking point. With Canada unable to provide affordable housing solutions fast enough for its record levels of new household formations, aspiring homeowners priced out of the market have been forced to turn to the rental market, driving apartment rental rates to historic highs and moving housing affordability to the forefront of Canada's national agenda.

Gone is the sleepy, simplistic multifamily market of yesteryear. Certainly, the sustained availability of low-cost CMHC financing still anchors the sector, making it currently the only asset class where positive leverage is still available and sustaining its appeal to investors as a defensive asset class. Nevertheless, today's multifamily operators need to navigate a more rapidly changing landscape than ever before and stay abreast of an array of increasingly complex variables.

Trending topics for multifamily operators to digest include:

- CMHC MLI Select financing products
- CMB securitization markets
- Energy efficiency
- Insurance costs
- Affordability
- Alternative housing options such as micro units, communal living, rental condominiums and single family rentals
- Public sentiment around the financialization of housing
- "Renovictions"
- Rent control
- Construction costs
- Government incentives to encourage development and the labyrinthine development approval process

Lots of moving pieces in this sector!

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Final thoughts

There is much cause for optimism across Canada's commercial real estate landscape. With Canada's stable government, high population growth, disciplined lending, sustainable construction, reliable market information, transparent legal framework and the strongest banking sector in the world, Canada's CRE sector is among the most attractive in the world. Office remains an area of concern, but there is remarkable strength in industrial, multifamily and, yes, even the retail sector. And hey, three out of four ain't bad!

The outlook for Canada's real estate finance sector is also favourable. The country's major banks are now halfway through renewal of their commercial mortgage books since interest rates began climbing in August 2020, with only minor impacts to their loan books and minimal defaults. The balance will largely be renewed by mid-2024 with similarly benign risk trends anticipated.[9]

The theme of this Market Update is change. And while change is nothing new in CRE, the pace of that change is happening faster than ever. Factor in the ever-present potential for an occasional black swan event like the pandemic, the inevitable disruptive innovation of new technology, and emerging issues such as looming ESG retrofit requirements to commercial properties that will impact their lending values, and you've got a rapidly changing real estate landscape that calls on today's CRE professionals to add change management to the essential skills in their toolkit.

Successful business minds know all about the importance of change:

"Change, preferably before you have to" – Jack Welch[10]

"What's dangerous is not to evolve" – Jeff Bezos[11]

In the context of the increasing pace of change in today's commercial real estate industry, perhaps the world's richest person said it best:

"You need to embrace change if the alternative is disaster" – Elon Musk[12]

[1] Canada Cap Rates & Investment Insights Q3 2023 | CBRE Canada.
[2] Lenders Plan to Loan More Money For Real Estate Transactions in 2024 | CBRE Canada.
[3] Commercial Real Estate Spring 2023 Market Update | BMO.
[4] Canadian Real Estate Lenders Report 2023 | CBRE Canada.
[5] Canada Office Figures Q3 2023 | CBRE Canada.
[6] Soft Office Market Fundamentals Persist | CBRE.
[7] Canada Industrial Figures Q3 2023 | CBRE.
[8] BMO estimates.
[9] BMO internal research.
[10] Winning by Jack Welch.
[11] Fast Company.
[12] The Daily Beast.

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