2022 RealREIT

ISSUE 81

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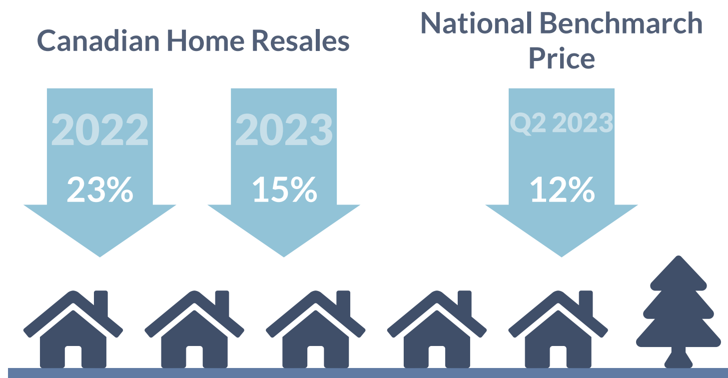
1. WHAT WILL RISING INFLATION, HIGHER INTEREST RATES AND A TURBULENT ECONOMY MEAN FOR REITS?

Higher interest rates are not necessarily bad news for REITs, as decreased demand and affordability will delay home purchases for many would-be buyers.

The Bank of Canada's 100 basis point (bps) rate increase announced July 13, 2022, exceeded most economists' predictions (most were calling for a 75 bps rate increase at most) and with the overnight rate still expected to reach 3.25% by October, this represents "a big bite for borrowers to swallow that will spoil or delay homeownership plans for many buyers. The hike took variable mortgage rates roughly up to par with fixed rates, effectively shutting the last window of super cheap borrowing costs available to buyers," according to RBC Economics Robert Hogue.

Earlier increases by the central bank began the course of market correction as early as March 2022, and RBC expects "the downturn will deepen in the coming months with both resale activity and home prices reaching lower levels than … previously anticipated." **RBC projections include a 23% drop in Canadian home resales in 2022 and a further 15% in 2023 and a 12% drop in the national benchmark price by Q2 2023 as demand and affordability weaken.**



Josh Nye, a senior economist at RBC, expects key Canadian trading partners, including the U.S., will be in recession in 2023. "In this environment we think it will be difficult for Canada to avoid a downturn of its own and we now look for GDP to decline in the middle quarters of next year, limiting annual growth to less than 1% in 2023."

Higher interest rates are not necessarily bad news for REITs, as decreased demand and affordability will delay home purchases for many would-be buyers. It is, in fact, good news for multi-family residential REITs, who will see less churn amongst tenants who are staying put until both home prices and interest rates once again begin to decline. REITs "are still attractive for investors when interest rates are rising because they offer steady distributions based on contractual lease agreements companies have with their tenants, as well as the ability to raise rents," according to Corrado Russo, senior managing director at Toronto's Hazelview Investments. Russo also told the Globe Advisor Weekly Newsletter (July 29, 2022) that REITs "typically outperform broader equities in the longer term. … [In] the 27 months between 2004 to 2006 when the U.S. Federal Reserve Board increased interest rates a whopping 17 times, or 425 basis points, to 5.25% from 1%, … REITs rose more than 30% and equities were up 8.5%."

By May 2022, Canada's inflation rate was 7.7%, while the U.S. inflation rate hit 9.1% in June. Huge increases in food and gas prices due to supply chain disruptions (including Russia's invasion of Ukraine) were the main drivers of inflation. The combination of higher costs for goods and higher interest rates means that, "When people do not have the borrowing power they need to take out mortgages, they will be forced to rent instead of purchasing houses. Rentals will continue to see greater activity as interest rates increase," according to Motley Fool's Adam Othman.

"REITs present a viable alternative to purchasing investment properties to gain exposure to the real estate market…. Economists suggest considering the cash flow and adjusted funds from operations per unit (AFFOPU) to Canadian investors when looking for ideal REITs to invest in right now [since] REITs with the highest AFFOPU have held a track record for delivering the best returns in the industry, not the trusts boasting the most significant asset value per unit," said Othman.

In mid-June 2022, a CIBC Capital Markets report pointed out that since REITs only refinance debt as mortgage terms come due, much of the debt that will be coming due in the near future was issued five years again when interest rates were similar to today's and the effects of higher interest rates in the REIT market probably won't be felt till 2025.

2. HOW HAVE REITS PERFORMED OVER THE PAST YEAR? WHAT HAVE BEEN THEIR MAJOR CHALLENGES?

The Canadian REITs industry was down 11% over the past year, and earnings are anticipated to decline.

In the last week of July 2022, the Canadian REITS industry rose 2.5%, due to a 3.1% increase from Canadian Apartment Properties Real Estate Investment Trust. The industry as a whole was down 11% over the past year, and simplywall.st anticipates earnings will decline 22% per year.

However, for investors, yield is far more important than stock price, and dividendearner.com selected the following four Canadian REITs as its best picks, based on their performance over the last year. They are: CT REIT; InterRent REIT; Granite REIT; and Canadian Apartment Properties REIT.

CT REIT's 325 retail, mixed-use, and industrial properties cover 27 million square feet of gross leasable area in Canada, with 69% of its base minimum rent generated by retail and mixed-use buildings and 31% by industrial. Canadian Tire Corporation is its biggest tenant. CT holdings are in major Canadian urban centres: Vancouver, Edmonton, Calgary, Toronto, Ottawa, and Montreal. Its strategy is growth through higher rents, acquisitions, intensifications, and development. With a market cap of $1.82 billion, its dividend yield is 5.10%.

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With more than 12,000 multi-family households primarily in Toronto, Montreal, and Ottawa (the National Capital Region), InterRent REIT has seen consistently strong demand for rental apartments as employment (especially youth employment) has increased, the Canadian population has aged, and international net migration has risen dramatically due to increased Canadian government immigration quotas and the influx of refugees from Ukraine. Its growth strategy is to expand in healthy markets with stable employment profiles that anticipate continued growth in population. InterRent's "social objective is to offer an unsurpassed resident experience. They believe that dealing with people is the heart of any business, and this is especially true in the multi-family sector since their business impacts someone's home." ("Best Canadian REIT Stocks," dividendearner.com) InterRent's market cap is $1.89 billion and it yielded dividends of 2.55%.

Industrial-focused Granite REIT, a Magna International spin-off (Magna is also its major tenant) has properties throughout North America and Europe, including manufacturing, corporate office, warehouse and logistics, as well as product engineering facilities, with multi-purpose, logistic, and distribution warehouses making up the bulk of its portfolio of 85 investment properties and 33 million leasable sf. With a market cap of $5.32 billion, its dividend yield is 3.84%.

Canadian Apartment Properties or CAPREIT is a growth-oriented investment trust. The REIT invests in residential properties, including apartment buildings, townhouses and land lease communities located in close proximity to major urban cities across Canada.

The largest Canadian REIT by market capitalization value ($8.40 billion) and the country's largest multi-family residential REIT, Canadian Apartment Properties REIT (CAPREIT) has interests in more than 51,000 residential units: over 44,000 residential suites and 32 manufactured home communities, as well as land lease sites near major Canadian and Netherlands urban areas. Its portfolio includes affordable, mid-tier and luxury apartments and its dividend yield is 2.99%.

Over the last year, repeated pandemic lockdowns and work from home mandates meant retail and office REITs suffered. For example, Morguard REIT's retail properties saw revenue drops between 5 and 8% in the first six months of 2022. Its assets are primarily retail and office, with industrial making up less than 1% of its revenue. While both retail and office sectors are expected to rebound, longer lease terms limit the ability to raise rents, so recovery of REITs that focus on these sectors will take longer. "In this environment of uncertainty, there are two REIT industries that have stood out in terms of performance – industrial and residential," according to stocktrades.ca.

3. THE GROWTH IN ESG AND REPORTING AS A FUNDAMENTAL ELEMENT OF REIT PERFORMANCE

Stakeholders are increasingly more interested in ESG performance, with focuses shifting from just environmental impacts to social ones as well.

"As REIT stakeholders become increasingly impacted by and interested in corporate ESG performance, the ESG journey for REITs and publicly traded real estate is urgent and accelerating," according to U.S.-based Nareit's "REIT Industry ESG Report 2022." **By the end of 2021, 98 of the 100 largest REITs by equity market cap reported on ESG performance, 60% of REITs publicly disclosed ESG goals (up from 53% in 2019), and 79% of REITs have cross-functional ESG teams.**

Reported ESG Goals | Disclosed ESG Goals | Have ESG Teams

Currently, the multi-family apartment market represents the lowest hanging fruit and the biggest wins in implementing energy efficiency programs, according to Marlee Kohn, Director, ESG, Starlight Investments. Deep retrofits of existing buildings (low flow fixtures, HVAC replacement, energy efficient appliances) are already underway or have been completed or planned. Building automation systems have huge effects and significant payback as technology has caught up to environmental demand while also getting cheaper. Buildings are seeing a 25% reduction in gas usage when high energy efficiency boilers are installed. "Electrify the building" is a huge step in decarbonization. The focus is shifting to the social impact of REIT-owned properties on the communities in which they're located, including diversity and creating stronger communities, supporting local economies and elevating the people who occupy the units.

Efforts to increase tenant engagement and create tenants who are also partners have financial benefits in terms of reduced utility rates both for tenants and building owners. Creating healthy, resilient buildings increases tenant engagement, especially post-pandemic, because "tenants understand how it affects them and their families, their air quality, and the amenities that they enjoy at the buildings. That's where you start to understand what will help make a better community for them," Kohn said in a March 21, 2021 podcast, "ESG in Action."

While electrifying buildings is not yet a reality since deep retrofits can't feasibly be done across an entire portfolio, the adoption of a "carbon lens" to ensure target dates are met has become part of the REIT planning process, since having a green building certification adds value.

Affordability is a social impact driver, and strong targets beyond energy, carbon, and green energy certification. Inclusion is now being incentivized in the former of lower interest rates as CMHC has recently launched new financing criteria that takes into account both energy efficiency and accessibility – linking loans to sustainability.

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How to translate ESG into investment performance? Real real estate results: figuring out materiality. Catherine Marshall, Principal, RealAlts, talked in the same podcast about how to translate ESG into investment performance. Executives need to lead the charge to ensure projects are completed, especially since there's a 54% payback in year one and total payback within two years.

Marshall sees tenant engagement as the point where the overlap between ESG policies and investment performance begin, and cited two innovative U.S. programs that focus on the social aspect of ESG, which reduces churn within multi-family buildings and may even delay home purchases.

One is an artist in residence program initiated during the pandemic in which young artists were provided with a small unit rent free for a year. The program was made very visible in the building, with events, and art shows scheduled. Relationship building was encouraged by having the artist-in-residence hold art classes with live models for the adults as well as children's art classes. During the pandemic, the feedback was that many of the tenants were reluctant to leave the property and the artist in residence program made tenants feel connected.

The second is an urban teachers program that offers reduced rent to high energy and enthusiastic young teachers so they will consider living in neighbourhoods and working in schools they might otherwise avoid.

Both Marshall and Kohn agree that the implication of modelling and forecasting is that some buildings are just not going to make it financially and there will be a significant amount of "divestment of the dogs," a brown discount in valuation of buildings that cannot be successfully retrofitted. This will become apparent as the carbon tax increases and will cause a shock to the market.

Regulatory change is the preferred and more effective driver for ESG. Europe has been very proactive in bringing in a whole host of ESG regulations and is far ahead of North America. Carbon tax increases to $170 per metric tonne by 2030 will lead REITs to divest themselves of properties that cannot be cost-effectively retrofitted.

4. WHAT WILL THE RETURN TO OFFICE LOOK LIKE? HOW WILL IT IMPACT NET ASSET VALUES AND LEASING?

Office tenants are focusing more on workplace safety, better digital tools, and ways to implement hybrid working models.

Darryl Wright and Jeffrey Wood of EY Canada produced a prescient report in December 2020, "Assessing your real estate requirements in the COVID-19 era." The results of a survey of more than 700 employers indicated 78% planned to change their remote work strategies and 74% planned "moderate to extensive" changes in real estate. Workplace safety was top of mind at the time, but 79% of respondents sought better digital tools to ensure both onsite and remote work was productive. "Flexible work arrangements are here to stay and fundamental, permanent changes to traditional workplaces and real estate portfolios are already underway."

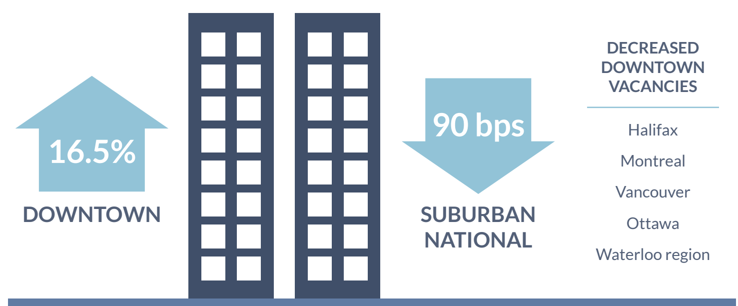
The greater office density of cube farms is a thing of the past, due not only to health and air quality concerns, but also because hybrid work models that see employees work on site three days out of five have proved viable throughout the pandemic and, in a tight labour market, employers are ready, willing, and able to accommodate staff. By the end of 2020, companies were "providing more choice to employees to work from home … reducing their overall footprint at workplaces, and … closing similar properties." (EY Canada)

CBRE's February 2022 Canada Office report stated that "[o]ffice market conditions are steadying following a challenging first quarter" although downtown centres lagged urban markets. The national vacancy rate for downtown Class B office towers was 21.0%. In Q2 2022, there was more than 15.1 million sf of office construction underway, a significant amount of which was in Vancouver and Calgary's suburban areas.

Q1 2022 saw 1.9 million sf of negative net absorption, although this figure improved dramatically in Q2, when there was only 463,000 sf negative net absorption. While suburban Vancouver saw the tech sector expand its office leasing, Toronto's declined due to tech-sector layoffs and economic uncertainty.

Just as homeowners (and renters) fled the downtown cores of major Canadian cities during the pandemic, **downtown office vacancy rates rose to 16.5% in Q2 2022, while suburban national office vacancy rates are 90 bps lower, with seven of 10 markets seeing lower suburban office vacancy rates. Halifax, Montreal, Vancouver, Ottawa, and the Waterloo region had decreased downtown vacancies, ranging from -10 bps (Waterloo) to -80 bps (Halifax).**

Office Vacancy Rates Q2 2022



As gas prices rose, commuting to downtown from the suburbs became far less appealing, and Class A buildings, "highly personalized space with quality amenities has become a cost of entry," while Class B buildings downtown had vacancy rates as high as 21% as "dated commodity office space becomes a relic of pre-pandemic times." The Class A downtown average vacancy rate was 6.3% lower than Class B.

In Q2 2022, six projects for a total of 835,000 sf of additional office space were under construction, most of it in the suburbs of Vancouver and Calgary. Vancouver's office building stock will increase 8.1% as a result, with 64.1% of the new space pre-leased.

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5. NOTWITHSTANDING HIGHER LAND, CONSTRUCTION & LABOUR COSTS, DEVELOPMENT CONTINUES AS MAJOR REIT STRATEGY

Many major REITs announced plans to invest in large projects across different market classes this year.

In October 2021, H&R REIT announced it was exiting the retail and office markets and would reinvest the proceeds "to fund H&R's significant multi-residential and industrial development pipeline." After selling the Bow office tower in Calgary and the Bell office campus in Mississauga for $1.47 billion gross, spinning off its retail and office properties should generate gross proceeds of $3.4 billion.

SmartCentres REIT, with a diversified residential, retail, and office portfolio, is investing $15.2 billion to develop Project 512, a mixed-use development that will include residential rents, condominiums, retirement homes, and hotels. In December 2021 it acquired a two-thirds interest in 53 acres at the Vaughan Metropolitan Centre at the northern terminus of Toronto's subway for $513 million, with the remaining one third owned by Penguin Group of Companies.

SmartCentres recently began construction of Phase 1 at its latest development, known as ArtWalk. The first phase features ground-level retail, and three towers (38, 18 and six storeys), with construction to begin with the next five years. Other SmartCentres developments include Transit City 1 and 2 towers, 55-storey multi-res buildings and a mixed-use 225,000-square-foot tower anchored by PwC's offices. (RENX.ca)

CAPREIT's 2021 annual report announced, "Our growing development pipeline will also generate future accretive growth. Over the long term, we have the potential to add approximately 10,000 new apartment suites to our portfolio through our intensification and redevelopment initiatives on our owned land."

Despite the battering office markets took during the pandemic, new development in suburban markets is adding to inventory, but is being pre-leased quickly. Downtown Class B office space is no longer very attractive when combined with the prospect of long commutes, highly inflated gas prices, and a lack of amenities.

In June 2022, RENX.ca reported that Choice Properties REIT had acquired a 75% interest in 154 acres of development land in East Gwillimbury, just north of Toronto, for $170 million from Rice Group, who will retain the other 25%. The property will become Loblaw's automated, temperature-controlled distribution facility.

"This development is a unique opportunity for Choice Properties to scale its existing industrial portfolio and further demonstrates the benefits of our strong and strategic relationship with Loblaw," said Rael Diamond, President and Chief Executive Officer of Choice Properties. "The development is a significant opportunity in a key market to develop industrial land," Diamond told RENX.ca.

Some REITs will divest multi-family residential units that cannot be easily and cost-effectively retrofitted to become energy efficient. As fossil fuel costs continue to rise, the sale of these properties will free capital for further new development of the best-performing REIT categories, multi-family residential, industrial, and retail.

6. INDUSTRIAL OUT PERFORMED ALL OTHER PROPERTY CLASSES: IS THIS INSATIABLE DEMAND SUSTAINBLE?

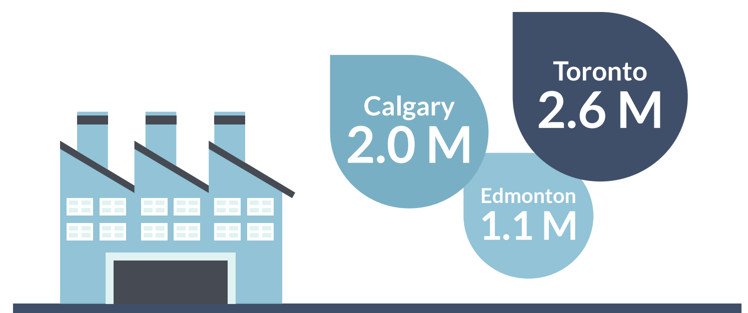
Net absorption is outpacing new supply for the seventh quarter in a row.

It seems hard to believe when the numbers are crunched, but net industrial rental rate growth increased 24.2% year over year in Q2 2022. Despite 6.1 million sf of new industrial supply deliver in Q2 2022, Canada's availability rate is still at a record low of 1.6%. All markets other than Calgary and Edmonton have availability rates below 2.0%. Availability rates dropped 20 bps or more in Calgary, Winnipeg, Edmonton, Ottawa, and Halifax, while London, Montreal, and Vancouver saw more modest available space increases (between 10 and 40 bps).

Construction levels nationally reached 43.9 million sf, but this figure represents only 2.3% of total inventory. The vast majority (more than three quarters) of industrial development projects are 200,000 sf or larger to meet the demand for large bay facilities.

Net absorption outpaced new supply for the seventh quarter in a row. **Toronto's net absorption was the highest in Canada, 2.6 million sf, representing new supply that was almost fully pre-leased. Edmonton net absorption was 1.1 million sf; Calgary's was 2.0 million sf.**

Net Absorption (square feet)



Third-party logistics, retail, wholesale, and e-commerce industries were the most active, and are creating demand for new supply that accommodates their requirements. Demand from this sector is moderating, however, in the first half of 2022 compared with the same period in 2021.

Of the 26.0 million sf of new supply under construction that will be delivered by the end of 2022, 74.9% is pre-leased.

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Net rental growth rates increased 24.2% year-over-year (Q2 2021 to Q2 2022), while the national average net rental rates reached a new high of $12.25 psf in the second quarter of 2022. Five years ago the national average was $6.79 psf. New supply is renting at well above market rates in response to inflation and increased construction costs.

Montreal saw Q2 2022 industrial rents increase 62.6% between Q2 2021 and Q2 2022, while Waterloo Region rents increased 39.5% and Toronto's 35.5%. Average net rent ranged from a low of $8.65 psf in London to a high of $18.93 in Vancouver. (CBRE Research, "Continued industrial demand sees heightening rental rate growth" Canada Industrial Q2 2022)

CBRE's summary of the industrial market:

"The rising share of e-commerce within retail has led to a prolonged period of high demand in the industrial sector. With industrial demand surging, the resulting low availability and high rent growth should continue to drive a strong supply response. However, some key risk factors could impede the pace of supply growth in upcoming years.

"In the short term, materials shortages and rising construction costs have caused some temporary disruptions to supply growth. Over the long term, construction wages, limited land availability and local and federal regulation remain risk areas for builders and developers."

7. BRICKS AND MORTAR RETAIL IS WITNESSING A RENAISSANCE AS IN-STORE SALES RISE WHILE ONLINE DECLINE

Online shopping in December 2021 was down significantly to $4535.23 million year-over-year, as Canadians flocked back to bricks and mortar stores.

Fueled by lockdowns and work-from-home mandates prior to vaccines becoming available, Canadian e-commerce adoption rates rose steadily during the early days of the COVID-19 pandemic. In December 2020, Canadian online sales hit C$4943.41 million, as baby boomers and millennials, the two biggest online consumer groups, were forced to adopt new purchasing methods with retail outlets hamstrung by maximum occupancy requirements and many smaller outlets experiencing financial difficulties despite federal pandemic assistance.

The 2020 federal Fall Economic Statement showed that retail e-commerce had increased 70% between January and August, while retail sales overall had declined by $33.9 billion in April 2020, shortly after the first series of lockdowns was applied throughout the Canadian provinces (Statistics Canada).

Online shopping demand followed patterns that, in hindsight, should have been predictable. "Think with Google" reported in May 2020 that by early March 2020, search interest for office chairs rose more than 100 percent, while by the end of April, with barbers and hair salons closed, interest in hair clippers had increased a whopping 800 percent.

Restrictions on store occupancy rates forced retailers to pay attention to their e-commerce platforms and offerings in a way they never had before, and to focus on innovative ways to maintain and increase sales. Curbside pick-up was increasingly adopted by retailers who needed to satisfy consumer demand from customers who didn't always want to wait for delivery. Retailers also began to focus on creating a more seamless return and refund policy for goods ordered online.

By December 2021, however, online sales were starting to decline as vaccinated Canadians resumed in-store shopping after months of pent-up demand. Online shopping in December 2021 was down significantly to $4535.23 million year-over-year according to Statista, while Colliers reported Statistics Canada data indicating retail e-commerce sales dipped 14.2% year-over-year to $4.1 billion in December 2021, 6.5% of total retail trade, with e-commerce sales share falling fell by 170 basis points year over year.

The advantages of bricks-and-mortar shopping include the ability to interact with items physically and assess quality rather than relying on web photos, no time lag between purchase and delivery (and no waiting at home for delivery to foil porch bandits), consultation with customer service representatives and sales associates, no shipping costs, and less likelihood of having to return unwanted items as a result of being able to see and feel purchases in-store, as well as ease of returning defective items without having to ship them back to online retailers. As pandemic restrictions eased, shopping as a social event that included visits to coffee shops, food courts, and dining with friends in the course of shopping trips, resumed as we emerged from lockdown.

According to Colliers' "2022 Retail Outlook Report," in 2021 "spending remained strong among industries related to outfitting and recreation" while gas sales increased dramatically "as people began to commute more to work and in general, to spend more time outdoors. This mainly due to the ease of restrictions within indoor spaces such as restaurants, malls, and other entertainment venues." While sales of clothing, accessories, retail trade and gas stations experienced decreases in December 2021 ranging from 1.8% to 9.5%, this was due to consumers modifying their behaviour to counter delays in shipping due to supply chain woes and began their seasonal shopping earlier than usual.

"COVID-19 forced many retailers to almost instantly adopt an e-commerce platform that up until March 2020 had been humming along just fine without it." This meant retailers had to adopt a "hybrid retail" model in order to survive, which will stand them in good stead now that lockdowns have ended. "Some retailers are shifting the footprints of their stores to include fulfillment and last-mile capacity … [while] smart in-store contactless product retrieval lockers" used by large retailers such as Walmart and Canadian Tire mean customers can both retrieve their purchases from secure lockers inside or outside stores, use their smartphones for seamless check-out, and make contactless returns via the lockers as well.

Retail vacancy rates declined dramatically over the course of 2021, with Ontario's overall retail vacancy rate falling 130 bps to 8.8% in Q4 2021, Quebec's declining 30 bps to 10.2%, and Alberta leading the way with the "lowest overall retail vacancy rate in Canada at 8.0%." (Colliers)

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8. MULTI-RESIDENTIAL REITS CONTINUE TO PERFORM WELL AS HOUSING DEMAND REMAINS VERY STRONG

As Canada recovers economically from the pandemic, demand has outpaced supply for rental units.

While the share price of multi-residential REITs may have declined since Canada's Liberal Prime Minister announced a power-sharing deal with the New Democrats to allow them to remain in power as a minority government until 2025 and promised to "crack down on the 'financialization of the housing market' by 2023", the sheer demand for housing in Canada and the unaffordability of single- or multi-family homes on the market has kept REIT distributions high and investors happy over the course of the last year.

The average Canadian vacancy rate in the purpose-built rental market was 3.1% (1.8% in the condominium apartment market), according to CMHC's February 2022 Rental Market Report. The national average two-bedroom rent was $1,167, an increase of 3%. Vacancy rates declined in 21 of 37 census metropolitan areas (CMAs), held steady in another 13 CMAs (including Montreal, which represents approximately 30% of Canada's total rental market), and increased in Toronto, Winnipeg, and Abbotsford-Mission.

Rental growth rates were down for the second year in a row, however. In October 2019 rents increased on average 3.9%; by October 2021 the rate was 3.5%, and in October 2021 it was 3%, lower than the inflation rate at the time and closer to Canada's historical average of 2.7%. **In the Greater Toronto Area, however, rents increased 5.7% between April and May 2022 and have increased 16.5% year over year**, according to Colliers "Greater Toronto Area Multifamily Market Report" for Q2 2022. The Ontario government has more than doubled the rent increase guideline for 2023, to 2.5% from 1.2% in 2022. Certainly in the GTA, "investors are recognizing attractive risk-adjusted yields in multifamily that may be difficult to achieve elsewhere."

Tenant turnover rates follow the same trend, with the average turnover rate increased to 15.5% in 2021 from 14% in October 2020 but still lower than October 2019's 17.3%.

Prior to the Bank of Canada's recent series of interest rate hikes, rental supply and demand were finally in sync, with an additional 40,000 purpose-built rental apartment units available by October 2021 (demand was 41,000). In October 2020, supply growth was about 26,000 units ahead of demand. "In a context of highly supportive monetary and fiscal policies, rising vaccination rates and the easing of pandemic-related restrictions have allowed economic conditions to recover much of the ground lost to the pandemic. This includes the employment of young people aged 15-to-24, a key driver of rental demand. When job prospects improve for young adults, renter household formation tends to increase since young adults find it easier to leave the family home for independent rental accommodation."

Another factor in increased demand for rental accommodation is the increase in net international migration, which was 45% higher in the first of 2021 than the same period of 2020. International students began to return to Canada in 2021 – there were 44.3% more international students in August 2021 than in August 2020, although there were still 6.8% fewer international students than in pre-pandemic times.

"The affordability of mortgage payments on a new mortgage has generally deteriorated faster since October 2020 as average home prices have generally outpaced rents in most centres. This deterioration likely increased the barriers to transition from rent to home ownership, particularly for lower-income households, further supporting rental demand as fewer renter households may have been able to make the transition to home ownership." (CMHC)

Greater Toronto Area Rent Increases

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Written by Ruth Seeley of No Spin PR

9. INVESTMENT ACTIVITY HAS GROWN SINCE Q3 OF 2020: WILL HIGHER COST OF CAPITAL CHANGE THIS TREND?

Cap rates are expected to rise upwards for the foreseeable future.

While investment activity has grown since Q3 of 2020, in Q2 2022 cap rates rose across most sectors and most Canadian geographies to their highest levels since the pandemic began. “While further interest rate hikes are expected to be less severe than the 100 ps jump seen in July 2022, it now appears likely that cap rates will continue to trend upwards over the near term,” according to CBRE’s Paul Morassutti (“Canadian Cap Rates & Investment Insights” Q2 2022 CBRE).

The highest cap rates in Q2 2022 were Downtown Office Class B (6.83%); Suburban Office Class B (7.44%), and Strip (non-anchored) (6.47%).

Carmin Di Fiore, Executive Vice President, Debt & Structured Finance at CBRE, said, “Given the new geopolitical realities tempering global growth for the foreseeable future, the central banks’ war on inflation will dominate the rest of 2022 and this will bring pressures on the short end of the yield curve.”

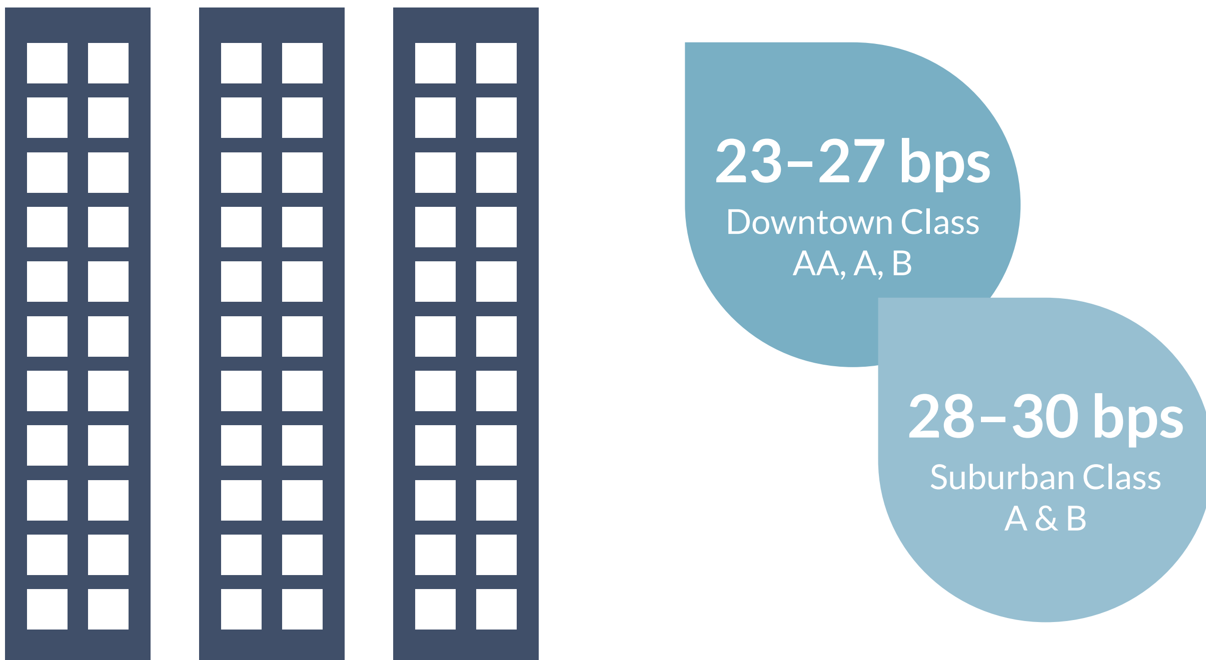
Office cap rates in particular increased in Q2 2022, **with Downtown Class AA, A, and B increasing between 23 and 27 bps, while Suburban Class A and B cap rates increased between 28 and 30 bps.**

Industrial cap rates increased for Class and B between 25 and 29 bps in Q2 2022. This represented the first increase in cap rates for Class A industrial properties since Q4 2013. “Given the compressed nature of cap rates in this sector, rising bond yields forced spread to untenable levels and upward pressures on the cost of debt are necessitating pricing adjustments at this time.” (CBRE)

Retail cap rates, already higher than in most other sectors, increased in Q2 2022, but only slightly, between 7 and 1 bps quarter-over-quarter.

In the multi-family sector, cap rates increased between 9 and 18 bps for High Rise Classes A and B, while Low Rise Cassess A and B increased between 5 and 12 bps. However, David Montresssor, CBRE’s EVP, National Apartment Group, said, “Despite cap rate guidance increases, the long-term underlying fundamentals remain very strong and investor interest remains elevated. A shortage of large-scale acquisition opportunities remains the primary impediment to increased activity levels.”

Office Cap Rate Increases — Q2 2022



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10. WHAT IS THE PATH FORWARD FOR REITS TO GROW IN 2023? WHAT ARE THE KEY STRATEGIES FOR CEOS?

Increasingly, Canada's property market is considered a "FOMO" market. Fear of missing out can, however, lead to buying at any price rather than at the right price, which is never a good strategy, especially when inflation is proving difficult to tamp down and interest rates continue to rise.

Canadian REITs, particularly those who own aged multi-family and downtown Class B office spaces, should consider divesting some of these properties so they can pursue development and acquisition plans and get out of less profitable sectors.

At the end of 2021, Motley Fool's Reuben Gregg Brewer wrote, "As you look at your portfolio holdings, you should pay extra attention to the cap rates that your REITs are talking about. The more they decline, the riskier the investments being made are likely to be. That's a particular problem in both strip malls and restaurants today, but not every REIT has the ability to just sit on the sidelines and wait for better deals."

As fossil fuel prices continue to rise and carbon taxes begin to increase, multi-family REITs should concentrate on retrofitting the properties they own to make them more energy efficient and work towards carbon neutrality. The benefits for both owners and tenants will quickly be reflected in the bottom line, thus maximizing profits. Investments in greater energy efficiency should pay off within two years, and investments in reaching the social and governance goals of ESG will ensure good tenants and less churn in multi-family residential properties.

Buildings that can't successfully be retrofitted should be redeveloped if feasible, and if not, REITs should divest and use the capital to finance new development or investment.

How do you optimize the investment lifecycle?

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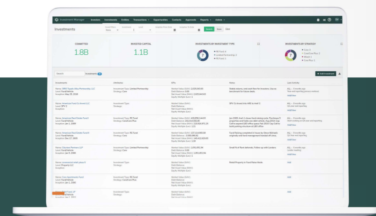

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