Five themes to watch in 2024

Canadian commercial real estate's delicate balancing act

December 2023

Five themes to watch in 2024:

The Canadian commercial real estate market has remained resilient in the face of COVID-19-induced accelerated change, inflation, high interest rates, and now weaker growth prospects. Here are the key themes we're watching as markets do their best balancing act.

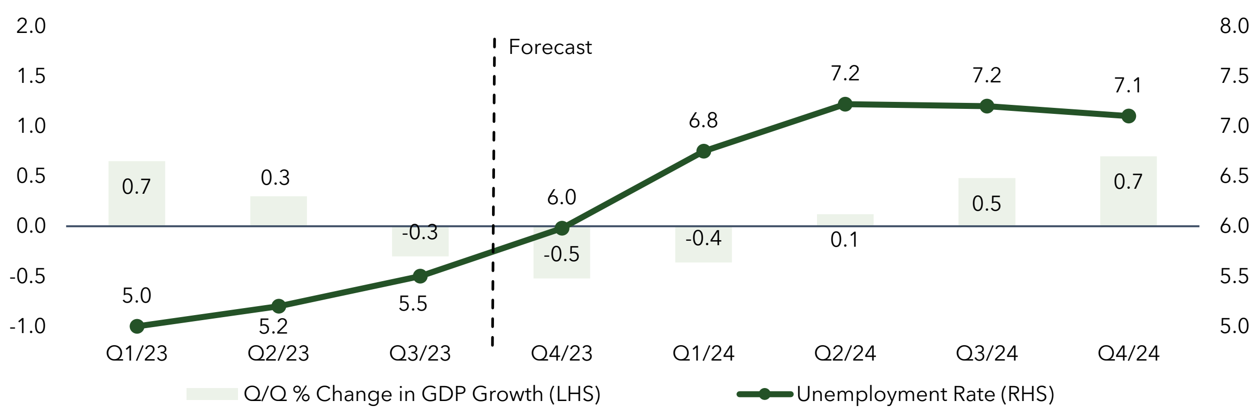
1. Downshifting economic growth: What does it mean for real estate demand?
2. End of the interest rate tightening cycle: How will it impact real estate capital markets?
3. Calling employees back to the office: Is 2024 a turning point for the sector?
4. Property returns are converging: Where is the likely source of outperformance?
5. Known unknows: What other downside risks are out there?

Downshifting economic growth: What does it mean for real estate demand?

Economic growth slowed significantly in the third quarter, contracting by 1.1%, well below consensus expectations. And while upward revisions to second quarter data prevented the economy from slipping into a technical recession, labels aren't what's important. Growth has stalled under the weight of higher interest rates.

The consensus outlook calls for a brief and shallow economic downturn, with growth picking up in the middle of 2024. If this scenario plays out, occupier demand should remain healthy, and well-balanced property fundamentals should continue to support rent growth across most sectors.

Canada Economic Outlook

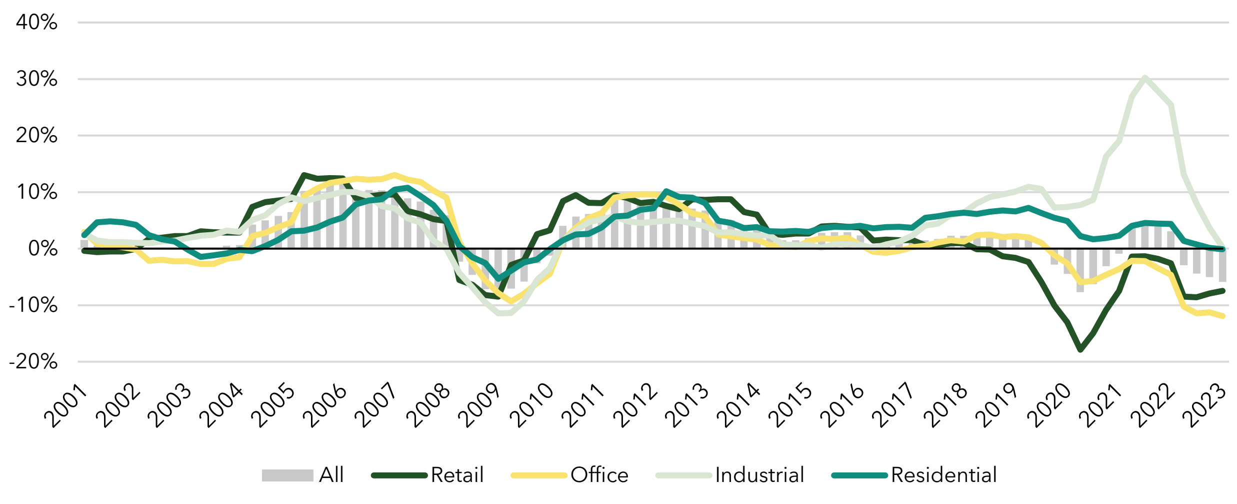


Source: Oxford Economics, December 2023

End of the interest rate tightening cycle: How will it impact real estate capital markets?

The third-quarter GDP contraction, combined with slowing inflation and a softening labour market, suggests that the Bank of Canada's next move could be to cut interest rates. While they will be wary of cutting too soon for fear of reigniting inflation, we believe a policy pivot will be a major theme for investors in 2024. A cut would be welcome news for real estate, but a clear end to the tightening cycle should be sufficient to stimulate investment activity, which has been depressed since the middle of 2022. With more clarity on the interest rate outlook, we should see more investors come off the sidelines to put capital to work. Increased activity will allow for greater price transparency, and we anticipate a bottoming phase in values during the first half of 2024.

MSCI/REALPAC Canada Property Index, 4-Quarter Trailing Appreciation Return

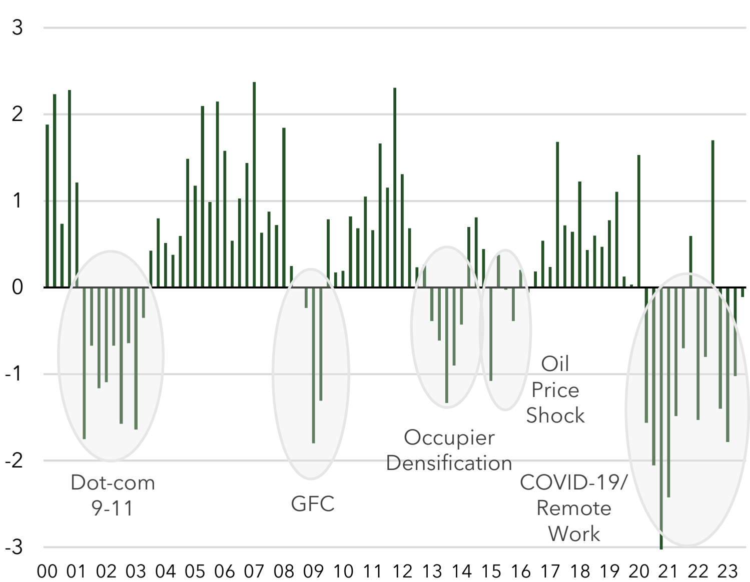


Source: MSCI/REALPAC Canada Property Index, September 2023

Calling employees back to the office: Is 2024 a turning point for the sector?

Unlikely. The sector will continue to be weighed down by hybrid work models, a slowdown in office employment, and new completions. Vacancy continues to rise, albeit at a slower rate, as absorption remains negative. More job cuts and the proliferation of generative AI within knowledge work are two additional headwinds that are likely to constrain leasing activity.

Canada: Downtown Office Net Absorption
(Sq. Ft., Millions, Quarterly)



Source: CBRE, September 2023

Due to a lack of transactional evidence, assessing office values has been difficult; however, appraisal-based office indices are down 17% from their pre-pandemic peak, and we expect further declines in the coming quarters. Given the long-term nature of office leases, the full impact of tenants re-evaluating their space requirements will take some time to manifest.

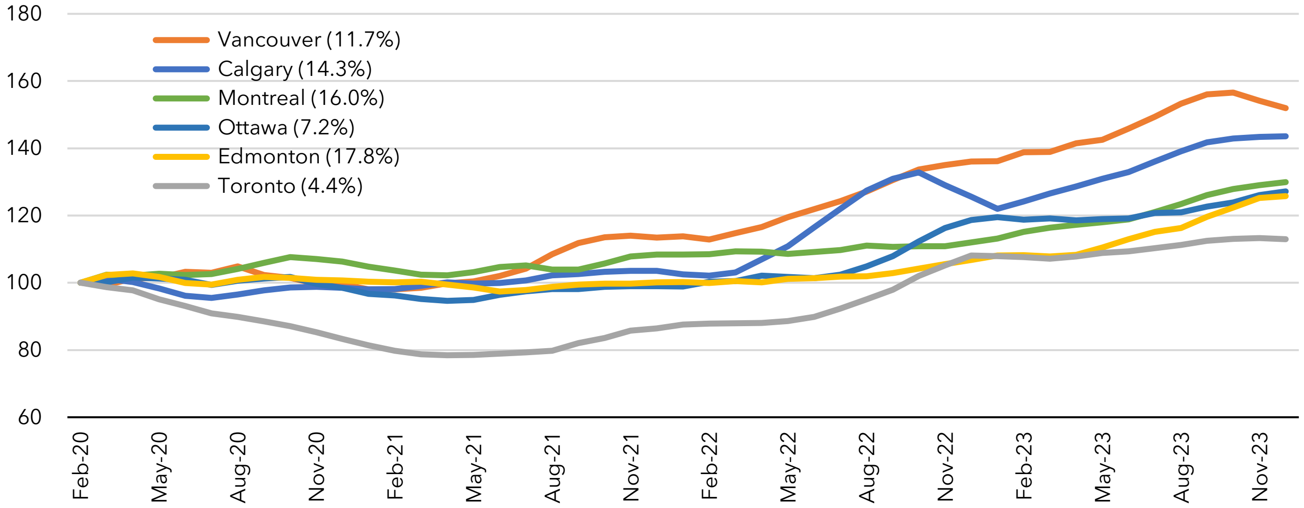
It's important to remember that not all office buildings are created equal. Tenants and investors clearly distinguish between best-in-class trophy offices that are well-located and highly amenitized and class-B, undifferentiated, "commodity" office space.

Property returns are converging: Where is the likely source of outperformance?

Multifamily is anticipated to be the top-performing sector this year. A lack of homeownership affordability and record population growth driven by immigration, particularly among the prime renter cohort (aged 25–34), will keep demand strong. There is evidence of slowing rent growth as more condo and purpose-built rental units enter the market, but Canada still has a structural housing deficit. And while recent government initiatives should help make the economics of purpose-built rental development more attractive, they are only one of many steps required to address Canada's housing crisis. As a result, we anticipate that the supply-demand imbalance will continue to put upward pressure on rents.

Multifamily Asking Rents

(Index: Feb 2020 = 100, Brackets reflect % change Y/Y)



Source: Rental.ca, December 2023

BGO

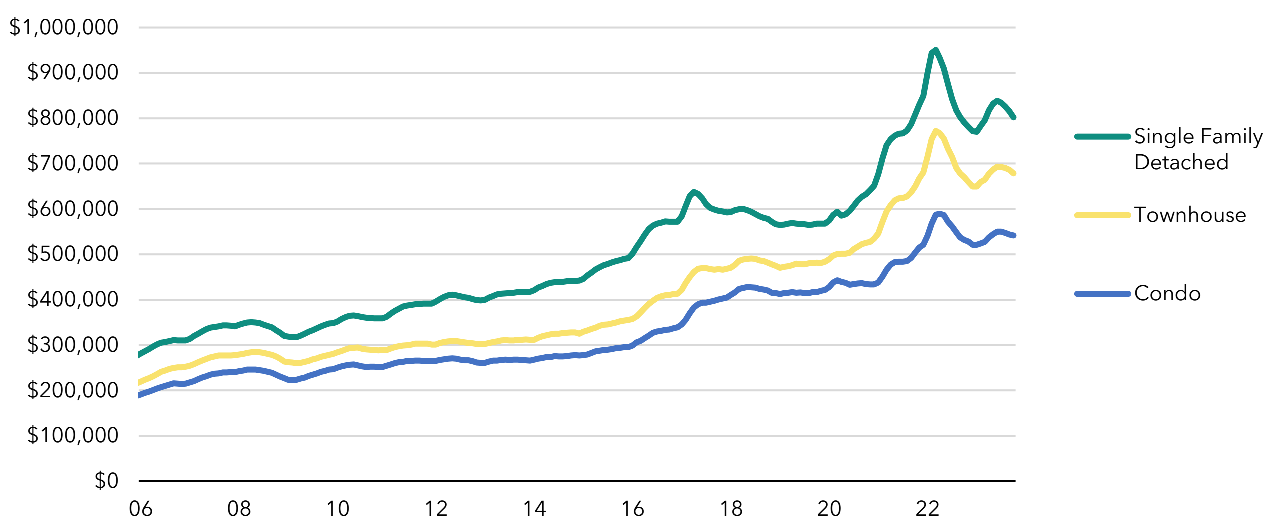
Known unknows: What other downside risks are out there?

There are several downside risks to our outlook. Firstly, the Bank of Canada is adamant about containing inflation, even if it means undermining economic growth and employment. The risk of holding rates high is that it sinks the economy into a deeper and more protracted downturn. Household budgets are already stretched due to rising food and mortgage costs, and there is a risk that if unemployment rises too much, there will be additional stress on the Canadian housing market, causing another decline in prices that will ripple throughout the economy.

Secondly, global growth is anticipated to remain weak in 2024, against a backdrop of heightened geopolitical tensions. Most importantly, while the US economy has outperformed expectations for much of 2023, recent indicators suggest that it may be cooling off faster than many had predicted. A deeper downturn with our largest trading partner would be detrimental to growth in Canada.

Finally, refinance risk continues to be one of the most significant near-term risks for commercial real estate. Floating rates combined with maturing fixed rate debt continues to cycle into significantly higher interest rates which is stressing cash flows. Borrowers are facing funding gaps as new loan proceeds are lower under higher interest rates and more restrictive underwriting metrics (lower loan-to-value and higher debt-service coverage ratios). Thus, borrowers need to close the gap by either paying down the loan with more equity, recapitalizing it, or selling the assets. There will be pockets of distress, but it's unlikely to be widespread.

Canada: MLS Benchmark Home Price, $CAD



Source: Canadian Real Estate Association, October 2023

Conclusion

In summarizing our outlook for the Canadian commercial real estate market in 2024, we acknowledge a landscape marked by both challenges and opportunities. Consensus expectation is for a brief economic slowdown, with a recovery on the horizon by mid-2024. This anticipated upturn should sustain occupier demand and support rent growth across various sectors. The potential end of the interest rate tightening cycle should rejuvenate investment activity, aiding in the stabilization of property values. However, the office sector may continue to face hurdles due to evolving work models and a slow pace of leasing activity.

Key risks, including the Bank of Canada's approach to inflation, global economic uncertainties, and refinancing challenges in a high-interest environment, need careful monitoring. Investors are advised to remain agile, balancing these risks with a strategic focus on long-term value. As we navigate through these complex times, those who adeptly understand and adapt to these market dynamics will be best positioned to capitalize on emerging opportunities in the Canadian commercial real estate landscape.

About BGO

BGO is a leading, global real estate investment management advisor, real estate lender, and a globally recognized provider of real estate services. BGO serves the interests of more than 750 institutional clients with approximately $110 billion CAD of assets under management (as of September 30, 2023) and expertise in the asset management of office, industrial, multi-residential, retail and hospitality property across the globe. BGO has offices in 28 cities across fourteen countries with deep, local knowledge, experience, and extensive networks in the regions where we invest in and manage real estate assets on behalf of our clients in primary, secondary and co-investment markets. BGO is a part of SLC Management, which is the alternatives asset management business of Sun Life.

The assets under management shown above includes real estate equity and mortgage investments managed by the BGO group of companies and their affiliates, and as of 1Q21, includes certain uncalled capital commitments for discretionary capital until they are legally expired and excludes certain uncalled capital commitments where the investor has complete discretion over investment.

For more information, please visit
www.bgo.com

Phil Stone
Managing Director, Head of Canada Research
BGO
phil.stone@bgo.com