Grant Thornton

2024 Real estate market summary: seeking optimism in uncertainty

Looking back, the theme for 2023 in the real estate industry was one of caution as investors and real estate owners braced for the effects of rising interest and inflation rates to stabilize. While inflation and interest rates seem to have stabilized, the overall economic picture for 2024 remains unclear.

Currently, many economists anticipate a global slowdown, with the intensity varying based on location. Globally, the World Bank expects the slowest decade of growth in 30 years, even considering the sustained strength of the US economy.

Closer to home, the Bank of Canada's (BoC) Monetary Policy Report – January 2024 predicted that inflation will remain close to 3% in the first half of the year and then slowly trend toward the target rate of 2%. The BoC also predicted that the overall economy will grow by just 0.8% in 2024 but rebound to 2.4% in 2025. This mirrors a Business Development Bank of Canada (BDC) report released in December 2023 that anticipates the BoC holding interest rates steady until at least the summer of 2024. Based on these indicators, the Canadian economy is going through a correction period and, while that can create challenges in the short term, such corrections can ultimately have a stabilizing effect.

BoC's 2024 vs 2025 growth predictions

2024: 0.8%

2025: 2.4%

Outside of economic pressures, the geopolitical situation is also contributing to a general sense of uncertainty and exacerbates existing challenges.

Heightened competition between economic blocs and military alliances has led to an increase in open conflicts affecting trade. For example, attacks on shipping lanes in the Red Sea are both stretching supply chains and increasing shipping costs as ships reroute around their travel patterns. Many nations are responding to the conflicts by limiting their dependency on overseas suppliers and prioritizing national production of economically significant products, further restricting trade flows around the world. Furthermore, new reporting rules under the Modern Slavery Act, increases scrutiny on supply chains of Canadian businesses, as organizations must disclose details about efforts to mitigate the use of forced and child labour at any point within their supply chains. Failure to comply may risk disruptions of shipments into Canada.

Finally, 2024 will feature important elections around the globe, including two of Canada's largest trading partners—the United States and Mexico—which could seriously impact the Canadian economy, investor sentiment, and trade dynamics.

With interest rates holding at current levels and predictions for sluggish growth in 2024, the real estate industry finds itself in a holding pattern. Major lenders have tightened their lending policies, limiting the industry's growth potential for the year. Firms able to secure financing are doing so at higher rates, which constrains profits and further limits growth.

With so much uncertainty surrounding current conditions, the Canadian real estate industry is generally taking a 'wait and see' approach for 2024.

Key trends

Risk management

The general economic uncertainty we currently face has left many organizations with less appetite for risk and a resultant focus on risk management. This has different effects depending on whether you're a lender or a borrower.

As lenders look to minimize their exposure to risk, they're focusing more on balance sheets. A company's project pipeline is becoming less important than their overall liquidity and ability to weather economic shocks.

To secure financing, borrowers need to get out ahead of their lenders and present a balanced risk profile. It will be increasingly important to present a transparent financial picture, get to know your lenders more closely, and get in front of renewals earlier in the process so that you have time to address potential concerns. Borrowers with less liquidity or poor cash flow are going to have a more difficult time securing financing, and those that do will see less favourable terms.

Development pressures

In terms of construction, we continue to see rising costs, especially in terms of labour.

80,000 vacancies exist in the industry, half of which are specialty trades contractors, according to CIBC.

The shortage is expected to continue putting significant pressure on the overall cost of skilled labour.

On top of the constraints imposed by labour, developers are also dealing with an ongoing lag in government approvals. Entitlement in both the industrial and residential classes is a particular problem and, while many municipalities have pledged solutions, current policies haven't yet addressed market conditions. This, combined with the lack of government incentives, has led some developers to move their operations to the United States.

A focus on the 'E' in ESG

As noted in last year's report, government commitments and associated regulations to meet climate change targets—both actual and anticipated—are expected to be one of the defining challenges for years to come. In advance of specific regulation, investors are pressuring companies to clarify their ESG and climate commitments to limit their exposure to regulatory risk. Yet, there still appears to be a gap between knowledge and action across the industry.

92% of respondents expect pressure—from investors, government, and even lenders—to integrate sustainability into financial statements and MD&As within the next five years, according to a REALPAC survey.

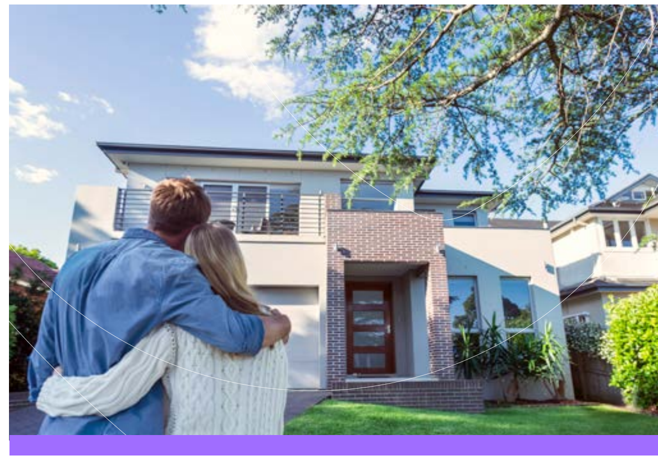
However, at this year's Real Estate Forum, REALPAC noted that fewer than 40% of companies even have an ESG commitment in place.

Whether there's a formal commitment in place, or leaders are thinking through their options, companies will require a mitigation plan that relies on either emission reductions or some kind of carbon offset. A significant majority (64%) of REALPAC respondents expect to reach their emissions goals without the need to lean on carbon offsets, whereas 36% say that they will be a necessary component of their strategy. Among those making use of carbon offsets, some say that credits are a necessity, because the path to net-zero simply won't ever make economic sense for their business.

Whatever the approach, it's clear that a large proportion of the industry will be looking to implement sustainable and green building practices and acquire appropriate certifications in the coming years.

While green initiatives are spreading quickly, companies are less certain about how social impact initiatives will be incorporated into their business in the next five years. Among REALPAC survey respondents, 11% don't think their company will be more socially responsible with the remaining 89% saying that they may be more socially responsible. In part, this reflects the priorities of lawmakers—governmental environmental targets are much clearer than social goals.

Asset class overview



Residential

Interest rate hikes throughout the first half of 2023 led to the continued decline of residential prices in 2023. Despite price drops, interest payments have gone up which makes it a challenge for buyers to qualify for mortgages or afford higher monthly payments. Buyers are treading cautiously, fearing further price drops as mortgages renew at sustained higher interest rates for the next few years.

172% DTI According to Rosenberg Research & Associates, interest rate increases have an outsized impact in Canada due to Canadian debt-to-income ratio.

At low rates, households can manage high debt, but as rates increase, buyers simply can't afford house price costs. Higher rates also put pressure on homeowners renewing their mortgages, which can lead to forced selling and a continued downward pressure on prices.

Affordability remains a continuous issue, especially in the rental market and for first-time buyers. Even with governments pushing for greater rental housing affordability, the expectation is that rental rates will continue to rise as developers try to make up for a 30-year deficit in rental projects, slow development process, high land and construction costs, restrictions in zoning, and skilled labour shortages. Even as the market tries to increase supply, the rate of population growth has exceeded the growth in availability of housing units and affordability exacerbating existing challenges, according to analysis from the Bank of Canada and Immigration, Refugees and Citizenship Canada.

Office

Office space has had one of the industry's most uncertain trajectories since 2020, but as tenants have solidified their work from home policies, the real estate industry is starting to see the shape the office market will take in the coming years. While it's clear the real estate industry won't see a return to pre-pandemic office use, it's increasingly clear that the office will remain a central component of our work lives. According to StatCan, the share of workers with hybrid arrangements has tripled since January 2022, whereas only 20% of workers now say they usually work from home down from nearly 25% in 2021. While that's still a massive increase from pre-pandemic levels, predictions of the office sector's demise were clearly premature.

As hybrid working has become the norm for office workers, quality office space has become an important strategic asset, resulting in an increased demand for flexible workspaces that can evolve alongside office policies. There is also a potential increase in the types of amenities available to draw employees back to the office—and, in some cases, to attract new talent to the business. Foremost among the demands in office space are parking/proximity to transit, size of meeting rooms, green/outdoor space, and ESG certification.

In contrast, less modern facilities with fewer amenities are being targeted for conversions to other asset classes, such as industrial or residential space. For example, the City of Calgary launched a downtown conversion program that aims to remove 6 million square feet of vacant office space by 2031 and create more than 2300 new homes in the downtown core. As of November 2023, they've approved 13 residential conversions, which are now in various stages of development.

Although the path forward is becoming clearer, the situation remains challenging for owners. With demand down and subleases rising, office rents haven't managed to keep up with inflation. Under such pressures, overall office REIT values are down 50 – 60% since 2020.

Industrial

Overall, the industrial real estate asset class continues to remain a strong asset class in relation to other commercial classes. The supply in major markets is constrained with Toronto, Montreal, Vancouver, and Ottawa seeing sub 2.5% availability rates.

However, availability rates are on the rise and demand is muted. In part, this is driven by a slowdown in e-commerce, which played a significant role in the supercharged performance of industrial properties. During the pandemic, as availabilities plummeted, Colliers noted that firms snapped up anything they could find to avoid being caught flatfooted if they needed space. Those businesses are now looking to shed unused space. Additionally, as economic uncertainty increases, businesses are holding onto making key decisions, including expanding their footprint. The net effect of these conditions is a lower growth rate. According to Colliers, the majority of the industrial market is showing less than a 10% growth rate, compared with 30% over the previous several quarters.

Retail

Brick and mortar retail has rebounded since the lows of the pandemic and we're now seeing a well-balanced market. According to JLL, demand has outpaced construction in this class over the previous three years, which has led to national vacancy rates falling to record lows. Aside from general economic interest rate pressures, the overall asset class is expected to remain relatively stable in the near term.

Alternative assets

After the industrial asset class, alternative assets are emerging as the class to watch. Broad demographic changes across Canada such as an aging population and growth in the number of university students has led to the concurrent growth of alternative assets such as retirement and long-term care facilities, student housing and co-living spaces, and health care facilities.

There are also more specialized assets that tend to cluster in specific geographic areas. The expansion of the information economy combined with privacy and data governance laws has led to growth in data centre facilities, which tend to be located in energy-producing areas such as Quebec and Alberta. There is also an increase in demand for biotech facilities in the GTA, based on the talent pipeline from nearby universities.

Overall, alternative assets accounted for 11% of all 2023 transactions with a 25% year-over-year increase in spending in this sector.

Opportunities on the horizon

Our trusted advisors are here to help you and your business mitigate challenges and seek opportunities in today's market. We can help guide you through real estate strategy, divestiture, acquisition and structuring, tax planning, tax and accounting reporting, risk management, audit and assurance.

Your business is our focus. Want to learn more? Let's talk.

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