

# Post-pandemic real estate opportunities and challenges

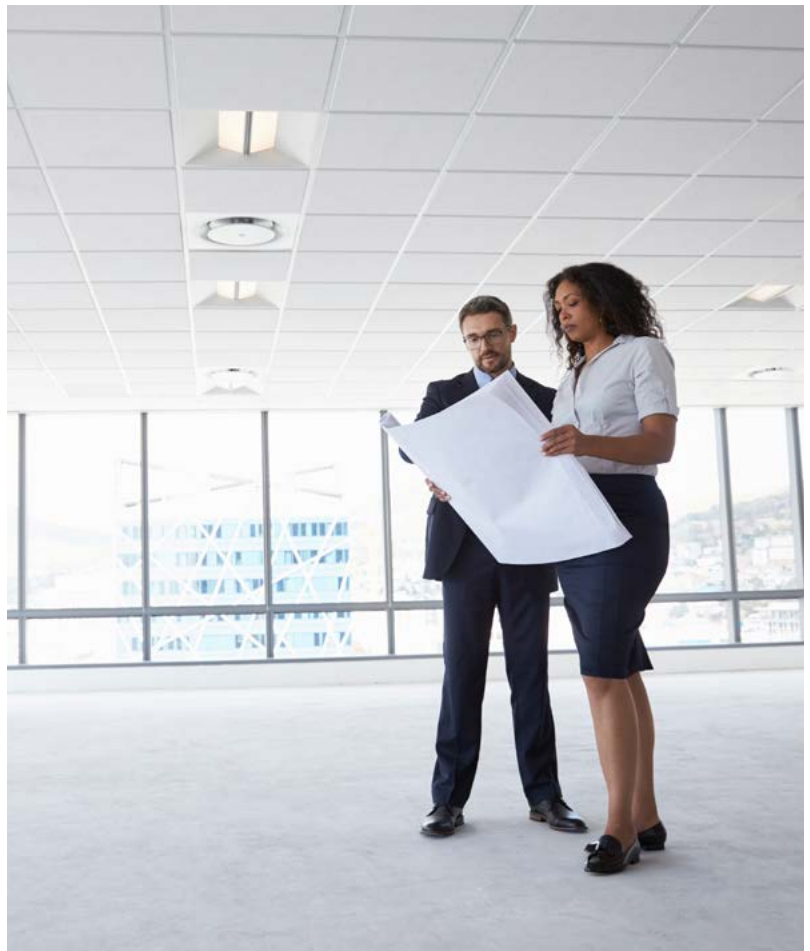
When COVID-19 first sent global economies spinning in March 2020, few could have imagined the long-term impact this pandemic would have. Now that countries are easing their restrictive mandates, the real estate industry must determine how to unlock the opportunities and mitigate the challenges associated with today's vastly altered operating environment.

Real estate developers, property managers, landlords, lenders and investors alike are now assessing the extent to which our cities, shopping, housing and workplace environments have changed. To explore these and other topics, leading real estate organizations came together—both virtually and in person—for the 30th Anniversary Real Estate Forum (the Real Estate Forum) held on December 1 and 2, 2021.

Throughout the Forum, participants explored a range of issues poised to alter the industry landscape—from mounting environmental, social and governance (ESG) mandates to the accelerating pace of digital adoption. At the same time, participants considered the ways in which ongoing labour and material shortages, and an increasingly complex economic environment, would affect the industry on a go-forward basis.

While complexities unquestionably abound, the real estate industry has long proven itself capable of responding to market volatility and shifting realities. Many organizations have already incorporated the lessons learned over the past two years to strengthen their operations, enhance tenant and lender relationships and position themselves for future growth.

Here, we delve into some of the ways in which today's industry leaders are revisiting their processes and practices in a bid to emerge from COVID-19 with solid foundations in place.





## A 2021 retrospective: Sectors in the spotlight

There is little doubt that COVID-19 shifted certain real estate fundamentals across the residential, office, retail and industrial sectors. To understand how those shifts affected industry players, it's useful to review the trends that emerged throughout 2021.

### Residential: Supply vs. demand imbalance rises

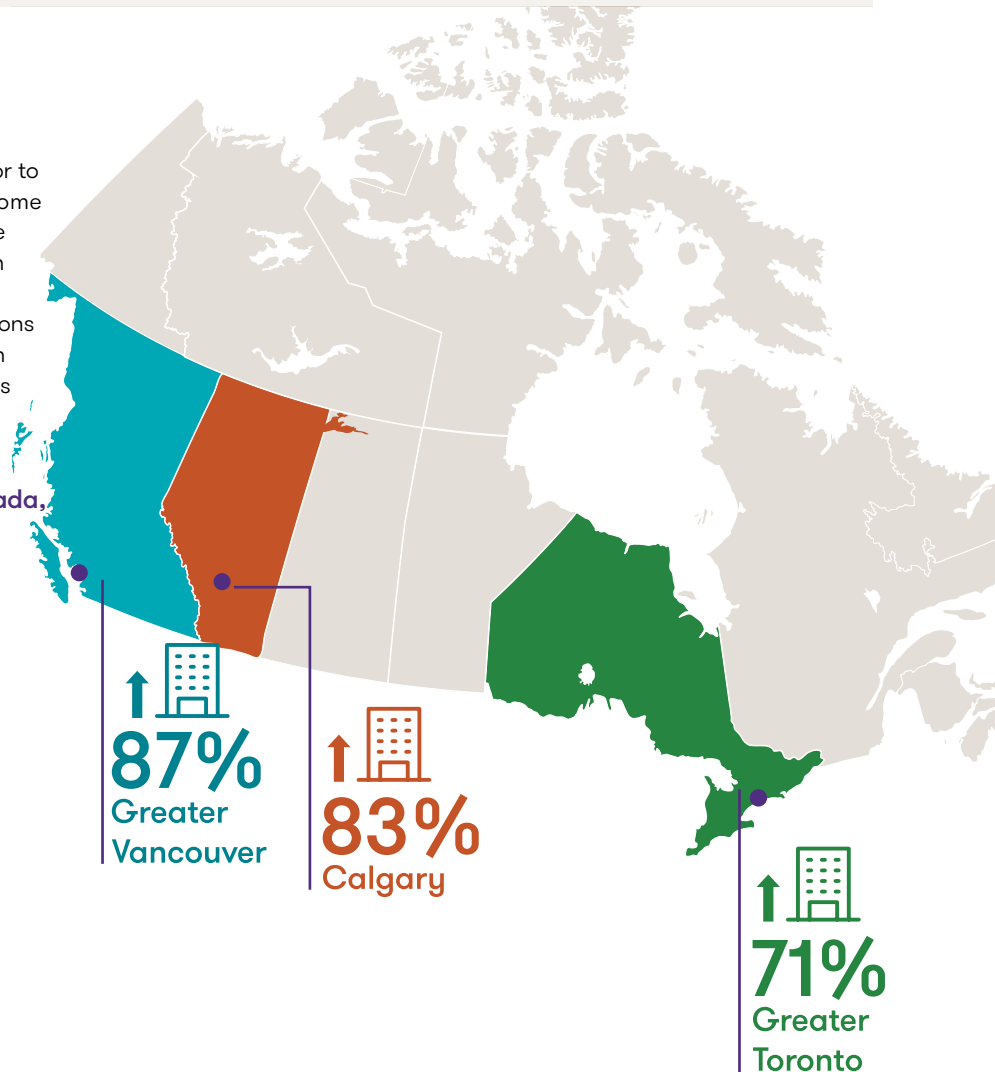
While remote work was already accelerating prior to the spread of COVID-19, nationwide work-from-home mandates created unprecedented demand in the housing market. After reaching an all-time high in 2020, Canada's housing market once again outperformed in 2021—with 21% more transactions than in 2020.<sup>1</sup> This red-hot demand, coupled with a drop in new listings, served to spike home prices across the country.



According to Statistics Canada, new home prices rose by

# 10.3%

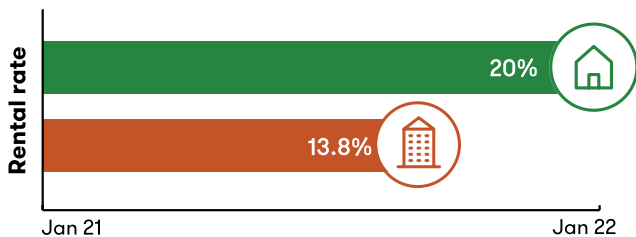
in 2021 compared to the previous year—the largest annual increase since 1989.<sup>2</sup>





With many potential homebuyers priced out of the market, condo sales climbed as well—rising by 87% in Greater Vancouver, 83% in Calgary and 71% in the Greater Toronto Area.<sup>3</sup> Not surprisingly, this avid activity has created a knock-on effect in the rental market.

Between January 2021 and January 2022, rental rates for single-family homes rose by 20%, condo rental rates rose by 13.8% and rates for rental apartments went up by 2.1%.<sup>4</sup>



Time will tell if this trend is set to continue as immigration to Canada resurges and university and college students begin returning to classrooms in earnest.

In light of this price growth, the issue of housing affordability is now squarely in the spotlight. Homeowners must now allocate over 37% of their disposable income to service a mortgage—the highest ratio since 2008.<sup>5</sup>

In the 2022 federal budget, the government has proposed to provide funding in several affordable housing initiatives to boost housing supply and address Canada's housing crisis.

These include:

- introducing a new Housing Accelerator Fund to help municipalities and communities create more affordable housing, with a target of 100,000 new units over the next five years
- extending the Rapid Housing Initiative to create at least 6,000 new units in the next two years
- supporting rent-to-own projects including funding to support companies to build new rent-to-own units



## Office: Returning to working together

It is likely no exaggeration to say that the almost-overnight transition to remote work caused by the pandemic represents one of the largest fundamental changes ever faced by the office sector. Prior to the Omicron outbreak in the fall of 2021, 50% of the Canadian workforce had returned to the office.<sup>6</sup> Of those workers who returned to the office, only 43% returned to a full five-day in-office work week, compared to 79% pre-pandemic.<sup>7</sup> In other words, over 78% of the Canadian office worker population was still working from home.

Throughout 2021, foot traffic in office buildings across six major Canadian markets had declined by 80% from pre-pandemic traffic rates—with a drop of 86% in Toronto, 67% in Vancouver, and 58% in Calgary.<sup>8</sup> And while vacancy rates are set to rebound

into 2022, uncertainty remains around future rental growth given the transition to new styles of work.

To address these altered realities, real estate organizations are stressing the importance of adopting new approaches. In a bid to attract workers back to the office, some property owners have introduced flexible lease clauses and shorter leases. Others are considering strategies for enhancing the tenant experience, with ideas ranging from the creation of activity-based workspaces to the adoption of technology solutions designed to foster tenant engagement.

Additionally, while a push for new construction remains, property owners are also pondering how to retrofit older buildings to integrate more options for food choices, leisure activities and the enjoyment of outdoor spaces.





## Retail: A tentative return

Subsequent to 2020, when Canada's retail sector saw its largest drop in sales since the 2009 global financial crisis,<sup>9</sup> 2021 marked a welcome resurgence, with sales rising by 11.6%<sup>10</sup>

Notably, the beneficiaries of this rebound extended beyond essential retailers such as grocery stores and pharmacies to include spending on cars, home improvement projects and even general merchandise and clothing, which resulted in boosted sales on the back of pent-up consumer demand.

Yet, despite this gradual recovery, in many ways the retail sector has been irrevocably changed. As COVID-19 forced the closure of poorly performing stores, retailers committed to survival recognized that innovation was imperative. In addition to the introduction of curbside pickup and direct shipping solutions, it also vastly accelerated the sector's move towards digitization.

While the entrenchment of e-commerce is the most obvious sign of this technologically-driven evolution, it is not the only one. Other digital solutions rising in popularity include the move towards

contactless payments and all-in-one shopping apps. This is positioning retailers to better leverage and potentially monetize the data they are collecting about consumer shopping habits.

At the same time, however, the sector must consider how to entice shoppers and tenants back to physical stores. Some landlords of enclosed malls who have lost critical anchor tenants have considered creating virtual stages consumers can access online to see the product options available to them. With reference to retaining and attracting tenants, there has been increased use of percentage rent (versus fixed cost) leases, which tie rental rates to sales. As such, it is likely that the most successful real estate organizations will be able to integrate the use of technology and physical attendance in stores to create an enhanced shopping experience.

The key to success will be for retailers to determine how to create highly differentiated in-store experiences in an increasingly digital world.





## Industrial: The latest darling

As became clear relatively early in the pandemic, the rapid transition towards e-commerce and need for logistics centres closer to consumers, created increased demand for industrial space. As a result, rental rates hit all-time highs in numerous markets across Canada, hitting a national average of \$9.65 per square foot (psf) by the fourth quarter of 2021.<sup>11</sup> In fact, net rates rose as high as \$16.47 psf in Victoria, \$16.31 psf in Vancouver and \$12.66 psf in Toronto.<sup>12</sup>



At the same time, vacancy rates continued to fall, with availability hovering somewhere between 1% and 2.2% in most key markets.<sup>13</sup> Although 21.7 million square feet of new supply came into the market in 2021, and another 34.3 million square feet is currently under construction, demand continues to outpace supply.<sup>14</sup>

Notably, these demand factors are not set to ease any time soon, particularly in light of the global supply chain bottlenecks that gaped open during the course of COVID-19. To mitigate the risk of similar global disruptions in the future, businesses are shifting away from traditional “just-in-time” supply chain models towards a “just-in-case” framework that is driving them to stockpile inventory. This, in turn, is further increasing demand for industrial and warehouse space in Canada. In fact, according to a recent CBRE report, “[b]ased on the historical correlation between occupied industrial space and business inventories in Canada, a 5% increase in inventory levels could boost occupier demand for warehouse space by an additional 90 to 120 million sq. ft. over the next few years.”<sup>15</sup>

As a result of this surging demand, new industrial builds are under rapid construction—and are set to leverage new technologies as well. As the CBRE noted in its report, investments in automation and robotics are on the rise in the industrial sector and will increasingly play a role in helping occupiers meet their operational and ESG efficiency targets.<sup>16</sup>

Yet another approach builders are taking to close the demand gaps involves looking for ways to enlarge traditional distribution centres. In Burnaby, BC, for instance, Amazon is constructing a multi-level industrial building that will span over 500,000 square feet.<sup>17</sup>



## A look at 2022 and beyond: Trends to track

Following the massive impact of COVID-19 on the real estate industry, real estate organizations are understandably motivated to get ahead of emerging trends so they can position themselves for future growth. Here we outline some of the top trends to track.

### Demand for ESG compliance ramps up

In recent years, there has been a persistent move to embed ESG best practices into real estate offerings. Numerous stakeholders are driving this charge—from investors seeking ESG-compliant products, to employees veering towards ESG-friendly employers, to tenants demanding more energy-efficient buildings. Regulatory pressure is also mounting as stakeholders call for higher levels of transparency and more stringent reporting requirements. In addition, lenders have gotten into the act as well, with many requiring proof of environmental sustainability before advancing funds or requiring companies to stress-test for climate change exposures.

All of these pressures have elevated ESG to a board-level issue. As a result, a rising number of real estate organizations are now looking at ways to reduce carbon emissions, enhance energy efficiency and screen for environmental risk.

Real estate organizations are now incorporating ESG strategies into their next projects. Several developers have already committed to building zero-carbon buildings, with a goal of reaching net zero by 2050. Some ways they are tackling this is by incorporating geothermal heating, deep water-cooling systems, solar panels, smart HVAC and other innovations into their builds. This is being supported by government grants that help to finance the installation of clean energy technology into new buildings.

At the same time, however, organizations must think through how to decarbonize buildings already in their portfolios. While government incentives are also available to retrofit older buildings, the task is potentially monumental. This is driving some owners to consider whether to “green” their existing assets or to divest. Admittedly, this raises challenges of its own as it requires owners to think through how to sell carbon-emitting assets.

In either case, one thing is clear: traditional reporting cycles and stakeholder demands for increased transparency are prompting companies to carefully consider how ESG fits into their business plans and reporting. To address these spiralling expectations, some real estate organizations are looking for ways to benchmark their ESG performance relative to their peers, identify emerging ESG risks and opportunities, integrate ESG into their long-term strategies and enhance confidence in ESG metrics and targets. This is critical not only to comply with more stringent regulations, but also to obtain better financing rates, command premium pricing from tenants committed to environmental improvement and attract sustainability investors by potentially issuing sustainability-linked bonds.

It is obvious that having a well thought out ESG plan will only rise in importance in coming years, mandating real estate organizations to enhance their ESG tracking and reporting.



## Digitization accelerates across real estate sectors

While digital adoption in virtually every industry has been underway for decades, the pandemic vastly accelerated the digital age by pushing the majority of the global population online. This extended far beyond online education and digital entertainment and has impacted the real estate industry in myriad ways.

For example, in the residential space, property owners and managers were already collecting property-use data in an effort to enhance the tenant experience and meet the needs of modern-day buyers. Other technology-driven innovations that have become the norm over the past two years include virtual tours, virtual home staging, property drone shots and video walkthroughs.<sup>18</sup>

Similar changes are afoot in the retail sector, where the shift to ecommerce has changed the way consumers shop. Following the lead of giants such as Amazon, some retailers have begun leveraging consumer data to create personalized homepages for online shoppers. Real estate organizations are using livestreams that may also develop as a new channel to help tenants highlight their brands in order to excite, educate and engage consumers more effectively. And as a growing number of consumers flock online, retailers will increasingly be able to use data analytics to enhance both the shopping experience (e.g., by offering solutions such as product matching and recommendation engines) and backend performance (through such functionality as demand forecasting and inventory prediction).

Malls, office buildings and other highly-populated spaces are also leveraging technology to enhance safety. Shopping mall apps, for instance, allow consumers to monitor crowd density, search for products and pre-order for accelerated (or curbside)

pickup. Some office buildings now also feature similar functionality, integrating AI-powered platforms to monitor such things as crowd density, air quality and energy use.

Digital innovation has even extended to the industrial space, where distribution centres and warehouses are implementing robots and drones to move inventory, improve efficiency and automate the loading of inventory onto delivery trucks.

Given the cost and labour savings associated with the move towards digital adoption, there is little doubt that these trends will only accelerate in the years to come.

## Critical inputs in short supply

One key theme that emerged during this year's Real Estate Forum was around the ongoing shortage of affordable housing units beleaguering the real estate industry. In recent months, media outlets across the country have been reporting on this housing shortage affecting countless markets. According to the Canadian Real Estate Association, 2021 ended with fewer properties listed for sale than at any point on record.<sup>19</sup> Despite the 28% increase in single-family home construction in 2021,<sup>20</sup> and the 19% increase in multi-family home construction,<sup>21</sup> supply is still falling well short of demand. Beyond losing an estimated \$10.5 billion in sales due to these disruptions, manufacturers are also facing almost \$1 billion in cost increases. Not surprisingly, the supply chain challenges are creating ripple effects in the real estate industry. Specifically, reduced availability of building materials has pushed up construction prices and continues to cause project delays.





According to a recent survey,<sup>25</sup> construction companies are struggling with shortages of everything from fixtures and finishings to plastics and paint. They do not even have access to the dump trucks required to support infrastructure projects. Taken together, this is fueling the most severe construction delays that the industry has seen in decades.

Labour shortages arising out of the so-called “Great Resignation” are also disrupting industry operations. In Ontario alone, more than 100,000 skilled trade workers are expected to retire within the next ten years,<sup>26</sup> which will disproportionately affect the construction sector. This has prompted several industry associations to call for increased immigration—a solution that will, in turn, spike demand for affordable housing.

To break this circular loop, employers are under pressure to do more than increase wages. To attract much-needed talent, organizations will need to adopt more innovative talent strategies—from supporting hybrid work and flexible work arrangements to granting in-demand talent participation in corporate profits.

## Economic volatility persists – inflation is rising

Given the supply chain and housing shortages prevalent across the real estate industry, it’s no surprise that inflation has been on the rise. For Q4 2021, Canadian real estate prices rose by 21.4% year-over-year, vastly outpacing similar housing price hikes in all other G7 nations.<sup>27</sup>

Thanks to this price surge, investment is flowing into the sector in search of higher returns. As of October 2021, over \$152 billion had poured into the real estate industry from private equity firms and institutional investors seeking diversification and a hedge against inflation.<sup>28</sup> With spreads tightening, there has also been a flight to quality, making multi-family and industrial spaces more attractive.

Yet, rising inflation also typically heralds interest rate hikes, which can affect real estate valuations. In fact, in April 2022, the Bank of Canada raised its policy interest rate by 50 basis points, inducing several Canadian banks to consider increasing prime rates as well.<sup>29</sup> Given the immediate impact of these moves on both mortgage rates and home line of credit rates, this long-anticipated move may serve to take the froth off the housing market. At this point, only time will tell.

## Going forward with confidence

With the disruption of the past two years potentially coming to an end, it's time for real estate organizations to turn their thoughts towards the future—while integrating the lessons learned throughout the pandemic. For many, this will mean getting more serious about walking the talk with reference to real estate opportunities, ESG commitments and performance or other issues affecting the industry. It will also fuel the ongoing adoption of digital technologies that promise to drive industry innovation.

To unlock these opportunities, however, organizations will also need to address some key challenges—including the ongoing labour, materials and housing shortages, as well as persistent economic volatility.

The good news is that the real estate industry has long been up to the task of responding to challenging times. At Grant Thornton, we're here to help. For instance, our ESG and sustainability services are designed to help you through each stage of your sustainability journey, from understanding the ESG matters most important to your business and stakeholders and building the infrastructure necessary to develop and communicate your organization's sustainability vision to

quantifying your current impact by measuring your current emissions, water use, air impact and data related to diversity, equity and inclusion. We can also support your team by designing a voluntary disclosure program to report your progress.

Whether you're looking to seize new opportunities in the post-COVID era—or get ahead of future trends now—we can assist with your real estate strategy and structuring, tax and accounting reporting, digital adoption program and talent strategy, while helping you lay the groundwork for success in any economic environment.

With deep experience in IT, digital, data strategy and project management, along with real-world knowledge of markets and customers, our digital transformation team understands the power of technology and is here to help.

Similarly, when it comes to supply chain management,<sup>30</sup> we understand how uncertainty can affect your business. Successfully adapting to change is complex—but you aren't alone. We can work with you to find the best way forward. No matter what opportunities you are seeking to unlock in the year ahead, we are here to guide you.

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