Grant Thornton

2023 real estate outlook: A year of cautious optimism

As the Canadian economy confronts conditions not seen in decades, the real estate industry is challenged with an uncertain landscape in 2023. A higher interest rate environment has led to higher capital costs across the industry and has put pressure on the cost of borrowing across all sectors. Higher than normal inflation has also continued to increase development costs as real estate owners struggle to keep up with rising supply charges. Considering these changes, the industry is already responding to meet the needs of developers, property managers, landlords, tenants, and investors. Canadian real estate players are taking a cautiously optimistic approach—finding new ways to adapt to changes and mitigate challenges, while keeping their eyes peeled for opportunities.

Looking ahead, all eyes are on the real estate industry to find ways to meet ambitious environmental goals and standards. Real estate players are prioritizing environmental, social and governance (ESG) in 2023, but are well aware of the challenges that lie ahead with implementation and complying with various regulations.

In the meantime, developers and landlords are still dealing with the long-term impacts from the COVID-19 pandemic in various degrees. For instance, companies are rethinking their office space needs to accommodate hybrid work models and add value to their employees' experience. The residential sector has cooled as pricing has moderated compared to previous years. The result is there's renewed optimism around the multifamily residential sector, as high borrowing costs are keeping younger prospective homebuyers in the rental market resulting in healthy leasing activity. The industrial sector, however, continues to boom with strong demand for industrial properties to meet the needs of e-commerce and fulfillment centres.

Participants at the 2022 Real Estate Forum were encouraged that what lies ahead is a sense of cautious optimism as opposed to an industry that is in a state of flux. Industry leaders across the board advised of opportunities available to those focused on making careful and strategic decisions with long-term planning and goals in mind. This report provides an overview of the current real estate market and key trends that industry leaders are paying close attention to in 2023.

Key trends

Cautious optimism

Real estate owners are taking a much more cautious approach when it comes to their investments and activity—whether it's forecasting further into the future, diversifying their portfolios, or sitting on the sidelines until market conditions and prices stabilize. Canada's real estate market is on a path of uncertainty with higher inflation and interest rates as well the general sense of an economic slowdown. In 2022, the Bank of Canada increased the overnight rate seven times, in an effort to gradually drive inflation down. These interest rate hikes brought the target overnight rate to 4.25 per cent by the end of 2022—the highest it's been since early 2008—followed by another interest rate hike to bring the overnight rate to 4.5 per cent on January 25, 2023. As a result, borrowing costs have increased from previous years and lenders are tightening their borrowing requirements, creating a significant barrier for companies to raise capital for the development of new projects.

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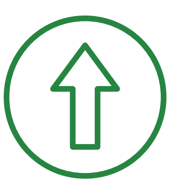

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However, the overall market is in a much better position compared to other periods of economic volatility. CIBC managing director and deputy chief economist, Benjamin Tal, who presented at the Real Estate Forum, believes the downturn will be milder due to a tight labour market and the significant savings that Canadians have managed to stow away. Tal predicts that the rate of inflation will decline by the beginning of the second quarter in 2023, once there are improvements in the global supply chain. However, Tal notes that getting to a two per cent inflation rate—the Bank of Canada's target rate—will be much more difficult, and perhaps not achievable until the end of 2024. Until then, it's likely that labour shortages, which limit increased production, and supply chain issues are expected to persist through 2023. These market challenges add to already inflated costs, which is causing inconsistent and often unexpected property valuations, ushering in a period of price discovery.

For many industry leaders at this year's Real Estate Forum, protecting capital and maintaining liquidity until the right opportunity comes along is the default strategy this year. Still, there are players taking a bolder approach—choosing to acquire assets that they consider to be safe investments. These transactions are likely happening in more stable classes, such as industrial, while leaning on trusted lenders that are willing to continue financing strong projects. In addition, many real estate organizations are spending this time focusing on modernizing aging assets to ensure they are prepared for a changing regulatory environment and maintaining their value in changing times.

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A focus on ESG

The global real estate and construction sector is responsible for consuming around 30 per cent of the world's energy and producing 27 per cent of its greenhouse gas emissions, according to the International Energy Agency[1]. Canada has joined over 120 countries in committing to be net-zero emissions by 2050[2]. While both investors and tenants generally support the fight against climate change, meeting these decarbonization targets will be no small feat. As a result, ESG performance is top of mind for Canada's top real estate organizations in 2023, but it's also one of their greatest concerns. In a recent survey by Real Property Association of Canada (REALPAC), more than 70 per cent of real estate companies anticipate that onerous government policies around ESG will constrain their businesses in the next five years, and 35 per cent of companies say their top business challenge is ESG implementation[3].

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A combination of new legislation and varied regulations across jurisdictions are contributing to the broad uncertainty that many in the real estate space are already experiencing. Several provinces have made net-zero commitments, including Newfoundland and Labrador, Prince Edward Island, and Quebec, while Nova Scotia and British Columbia also have provincial net-zero-by-2050 legislation in place[4]. Separately, several Canadian cities are also making commitments to meet these goals, including Vancouver, Toronto, and Halifax. Industry leaders at the Real Estate Forum specifically noted that one of the biggest hurdles before them is making sense of reporting requirements in different regions. With compliance top of mind, pressure from shareholders, occupiers and investors are mounting, with growing concern around the capital required to modernize aging buildings, or the risk of depreciation of assets.

Regardless of the challenges presented by regulation and legislation, the time for talk is over. Real estate organizations must prioritize putting their plans into action and taking steps to reduce direct and indirect emissions from the construction of new builds and refurbishments. To start, companies should consider mapping out legislation and regulations by jurisdiction and how these rules translate across markets and asset classes. Stakeholders should identify areas in which rules overlap or differ and set reasonable and achievable targets over shorter periods of time. Retrofitting buildings will also be a critical next step as ESG performance will be a key factor for attracting not only investors, but clients and tenants. Net-zero buildings are achieving record rents, with occupants willing to pay a premium for space that mirrors their organizational values and helps them achieve *their* net-zero targets.

According to venture capitalist firm, Fifth Wall, an $18 trillion investment is required over the next decade to get the real estate industry to net-zero[5]. Though this is a significant investment, there are a variety of plans to facilitate the transition to a greener economy. For instance, the federal government intends to issue green bonds to mobilize capital in support of climate and environmental objectives, while providing investors with green opportunities. Outside of government intervention, data and new property technology to achieve smarter, safer and more energy-efficient buildings are expected to be critical developments necessary to meet these lofty goals.

1 International Energy Agency, September 2022, "Buildings: A source of enormous untapped efficiency potential." https://www.iea.org/topics/buildings

2 Government of Canada, January 27, 2023, "Net-Zero Emissions by 2050." https://www.canada.ca/en/services/environment/weather/climatechange/climate-plan/net-zero-emissions-2050.html

3 Real Property Association of Canada, November 30, 2022, "REALPAC Prospective Survey 2022." https://realpac.ca/product/2022-realpac-prospective-survey-results/

4 Government of Canada, "Net-Zero Emissions by 2050."

5 Fifth Wall, March 18, 2022, "Creating impact at scale for the world's largest and most influential corporations." https://fifthwall.com/about

The evolution of asset classes

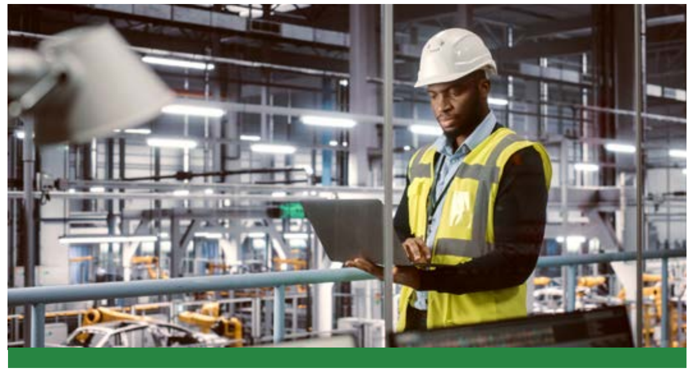
In 2023, certain real estate asset classes are in a state of uncertainty, as the industry is still experiencing long-term impacts related to the pandemic. For example, the office space sector is transforming in response to shifts in people and culture, including changes to accommodate hybrid work practices. In contrast, other asset classes, such as industrial and multifamily residential sector, appear to be following similar trends to 2022. Investor interest in these areas will likely continue through the year, and the demand for retail space will continue to evolve with shifts in e-commerce trends. Here, we'll highlight the asset classes to keep a close eye on.

Office

It's difficult to predict how the office sector will take shape in 2023, as leasing demand and building occupancy varied significantly through 2022. But one thing is for sure—the sector is innovating to meet changing needs. According to the REALPAC survey, almost 70 per cent of leaders and professionals believe a hybrid environment with flexible work arrangements is here to stay, and 78 per cent believe employees will come into the office around three to four days a week on average[6]. While many companies are growing more confident with implementing hybrid work models, decisions around office space have become more challenging. Companies have noted that it's become difficult to budget how much space they actually need, and consider whether reducing square footage could help cut costs. However, with peak interest rates and an increasingly uncertain economic outlook, tenants may be more hesitant to make drastic moves, and could instead try to modify their current space to suit their demands. Industry leaders at the Real Estate Forum are seeing a shift from viewing "office as a space" to "office as a service". For example, some companies are turning their office space into a multi-use facility—renting out open areas for events on evenings and weekends. In other cases, companies are investing in creative amenities to attract employees back to the office and away from their home desks. Business-software maker, Intuit Canada, told the Globe and Mail that, when designing their new office in downtown Toronto, their goal was to have a purpose-built space with employees in mind[7]. They've incorporated amenities such as coffee and snack bars on each floor and recreation areas with pool, shuffleboard, air hockey, basketball, and foosball.

6 Real Property Association of Canada, "REALPAC Prospective Survey 2022."

7 The Globe and Mail, January 19, 2023, "Attracting workers to the office with food, games and the comforts of home" by Wallace Immen. https://www.theglobeandmail.com/business/industry-news/property-report/article-attracting-workers-to-the-office-with-food-games-and-the-comforts-of/



Industrial

The industrial asset class is still by far the top performing—carrying on a similar trend from 2022—with robust demand, supply constraints, and increasing rent prices. At the end of 2022, national vacancy rates in Canada's industrial sector dropped to 0.9 per cent, according to Colliers[8]. The tight industrial market is likely here to stay, with 64 per cent of industry observers surveyed betting that industrial will be one of the most desirable asset classes over the next five years, and 70 per cent expecting rents to increase in that time[9]. These market conditions are likely a consequence of the pandemic, as companies increased their inventory management strategies, from just-in-time to just-in-case to mitigate supply chain issues. In addition, US-led reshoring elevated transportation and logistics costs and caused delays in delivery. However, the industrial sector doesn't come without its own challenges to consider. Occupiers are considering ways they can cut costs, whether it's buying industrial property themselves to escape rising rent rates, splitting the space with a co-tenant, or using a third-party logistics partner instead of carrying the cost and responsibility themselves. Still, the industrial sector remains a stable option for industry players. Even if e-commerce activity slows through a possible economic downturn, the need for logistics and fulfillment centres will likely continue to drive demand.

8 Colliers Canada, January 12, 2023, "National Market Snapshot Q4 2022" by Adam Jacobs, Leo Lee, Susan Thompson, and Max Shapinko. https://www.collierscanada.com/en-ca/research/national-market-snapshot-2022-q4

9 Real Property Association of Canada, "REALPAC Prospective Survey 2022."

Residential

Although residential housing prices have softened, multifamily housing or purpose-built rental apartments is garnering renewed interest in 2023. This sector will continue to see high demand and very short supply. Canada's apartment vacancy rate plummeted to 1.9 per cent at the end of 2022—the lowest level in more than two decades, and well below the 3.1 per cent vacancy rate at the end of the previous year, according to the Canada Mortgage and Housing Corporation[10]. This tight rental market can be attributed to a steady increase of new Canadians, international students, and the impact of higher interest rates that have resulted in more Canadians opting to rent than to buy. The higher interest rate environment has also posed a barrier for builders, along with elevated construction costs, and labour shortages, as previously discussed.

10 Canada Mortgage and Housing Corporation, January 26, 2023, "Rental Market Report." https://www.cmhc-schl.gc.ca/en/professionals/housing-markets-data-and-research/market-reports/rental-market-reports-major-centres

Retail

As with other asset classes, retail is preparing for a potential period of economic uncertainty and examining current pricing methods. Retailers are looking to maximize sales while pricing in a continued period of inflation anticipated to drive material and supply costs higher.

However, the retail asset class has already begun reshaping itself through the use of technology and automation. Automation is transforming inventory management and retailers are looking to new offerings such as virtual reality tours to expand access to customers and enhance brand loyalty.

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Opportunities on the horizon

The real estate market is moving through a period of uncertainty, but industry leaders remain optimistic. Even though many real estate organizations are more careful with their capital, opportunities are growing. Activity is expected to resurface as prices stabilize and an appetite for risk will return as borrowing costs settle.

There's no doubt that the real estate industry is resilient—but navigating these uncertain times is far from easy. At Grant Thornton, we're here to help you mitigate the challenges of today's market and support you as you seek out the opportunities that meet your risk tolerance. We've got the support you need to help you build and action your sustainability goals, while helping you stay compliant wherever you operate. Our trusted advisors can help guide you through real estate strategy, divestiture, acquisition and structuring, tax and accounting reporting, adopting new technology and bringing on new talent.

We can work with you to support your goals in 2023. Want to learn more? Let's talk.

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