Grant Thornton

Top real estate opportunities and risks

What trends are driving the Canadian real estate sector, and what impact could they have on your business?

From global macroeconomic forces to the latest innovations in real estate-focused technology, our specialists are constantly on the alert. We've summarized the key takeaways from the National Real Estate Forum held in Toronto in December 2019.

Global economy: Outlook subdued amid trade tensions

The outlook for the global economy is muted amid ongoing geopolitical tensions, the beginning of a trend toward de-globalization and the contraction of trade for the first time since the last recession. Globally, growth has been slipping for the past 21 months. Global economic activity remains weak, with growth forecast at 3% in 2019—the lowest level since 2008.[1] While growth is expected to pick up modestly to 3.4% in 2020,[2] a more tepid pace of global activity may materialize in light of slowdowns in China and the United States, as well as other prominent downside risks.

There are conflicting views as to whether or not a recession is on the horizon, resulting in heightened levels of uncertainty. Both globally and in Canada, excessive debt is stifling growth. The World Bank identified rapid accumulation of debt as a threat to global economic growth, with the global debt-to-GDP ratio reaching an all-time high of 322% in Q3 2019.[3]

Global debt-to-GDP ratio reaching an all-time high of **322% in Q3 2019**

The Canadian economy has slowed[4] as exports and investments weaken, consumption falters and the debt to income ratio expands. Growth is expected to be about 1.5% in 2020. In December, the Bank of Canada decided to hold interest rates at 1.75%,[5] citing early evidence that the global economy is beginning to stabilize and growth will increase in the coming years. Although officials may continue contemplating cutting interest rates to keep the Canadian dollar low to mitigate the impact of trade conflicts, expectations are that rates will remain unchanged in 2020.

Investment in real estate market down, but fundamentals remain strong

Despite a decline in overall investment activity, fundamentals for the Canadian real estate market remain strong, according to Altus Group.[6] In Q3, national investment volume year-to-date fell 16% to $34.6 billion compared to the prior year period.[7] During the quarter, 1,838 investment property sales transactions over $1 million were recorded across Canada, representing a total value of $12.1 billion, down 7% from the prior year period.[8]

1,838
investment property sales transactions **over $1 million** were recorded across Canada

According to CBRE, national commercial real estate investment volumes totaled $10.9 billion over 1,773 transitions in Q3, representing the second straight quarter in which national volumes exceeded $10 billion. While the volume was down 7.3% quarter over quarter, it remained above the five-year trailing quarterly average of $9.3 billion. Year-to-date volumes, as of Q3, reached $31 billion, which is on par with record-setting levels observed in 2018.[9]

Global investors are shifting their attention from the United States to Canada, which remains a sought-after market for investors looking for safe returns and is becoming more attractive due to the perceived increase in geopolitical risk in the United States. Though lenders remain active in the Canadian real estate market and lending allocations are expected to remain stable in 2020, CBRE cautions[10] that lenders are closely watching the global environment and managing their risk profile through heightened diversification and an emphasis on quality assets. Lenders are targeting assets with strong rent upside potential in gateway markets such as Toronto, Ottawa, Vancouver and Montreal.

Residential market rebounding as multi-residential asset class attracts investment

The housing market is starting to stabilize[11] amid strong demand for housing due to population growth[12] and lower mortgage rates. According to Statistics Canada, housing investment grew 3.2% in Q3[13]—the fastest pace since Q1 2012—as new home construction increased and resale activities expanded in BC and Ontario. Residential land accounted for the largest share of investment volume (19%) in Q3.[14]

The Canada Mortgage and Housing Corporation (CMHC) expects the housing market to recover in the next two years as household disposable income expands.[15] Home prices are expected to trend upward in 2020 and 2021. Royal LePage expects home prices to appreciate 3.2% in 2020, with the aggregate price of a home reaching $669,800 amid healthy buyer demand and an uptick in the number of immigrants purchasing homes.[16] However, CMHC cautions that ongoing trade tensions and elevated household debt still present risks to the economy and stability in the housing market.

With new construction not keeping pace with demand for rental housing and the costs of home ownerships increasing, the market is seeing heightened appeal of multi-family assets.

National investment in the multi-family sector reached an estimated **$3.9 billion**

In H1* 2019, national investment in the multi-family sector reached an estimated $3.9 billion[17] fueled by low vacancy rates and the asset class' perceived capacity to maintain strong fundamentals during a downturn. According to CBRE, investment volume for multi-family classes has grown for four straight years, peaking at $8.3 billion in 2018.[18] In Q3, investment volume reached nearly $1.8 billion.[19] Though a lack of available product has weighed down overall volumes, multi-family remains the top performing commercial property type in North America.[20] Rental growth has also accelerated, with average rents for purpose-built rental units increasing 4.4% annually at the national level over the past two years.[21]

Industrial asset class seeing strong fundamentals, but low availability hindering investment

Demand for industrial space is burgeoning, with the national vacancy rate hitting a historic low of 2% in Q3 2019.[22] The sector is experiencing record-setting fundamentals as demand intensifies for larger facilities. However, the sector remains undersupplied, driving land costs and rental rates upwards and putting pressure on developers to quickly increase supply. New projects under construction totaled 30 million square feet in Q3, 18 million of which is pre-leased.

*H1 refers to the first-half of 2019

New projects under construction totaled
30 million
square feet in Q3

Though development intentions have increased, actual construction activity is low as a percentage of inventory, heightening competition for space. With limited development activity, industrial rents are higher and more rental growth is expected going forward. As demand grows, requirements for industrial buildings are also becoming more innovative, with clients seeking new, more modern facilities in place of older industrial spaces that are increasingly becoming obsolete.

The asset class is attracting strong levels of investment, accounting for 19% of investment volume[24] as of Q3, though the shortage of available product is dragging investment volumes down. Investors remain underinvested in industrial real estate in their portfolios. The asset class is expected to be most prosperous in the near-term. Investment volume for industrial product totaled $6.5 billion in the quarter, up 8% over the prior year period.[25] CBRE finds that acquisitions for the industrial asset class totaled $3.1 billion in Q3.[26]

Retail volumes down as sector transforms to meet changing demands

As of Q3, national retail sales volume was down almost 27%, according to Altus, as the market undergoes a period of disruption. Stores are closing as retailers try to find the right mix of digital and bricks-and-mortar presence. However, total transactions dropped only 5%, suggesting that, while the sector is transforming, investors are still active. In the first three quarters of 2019, the retail sector accounted for 12% of total investment, accounting for about $4 billion over 1,025 deals.[27]

The retail sector accounted for about
$4 billion over 1,025 deals

CBRE notes that lenders are cautious of retail transactions, with 26% of lenders saying they plan to decrease exposure to retail in 2020.[28]

Landlords and retailers are integrating more consumer experiences, new food concepts and improved designs to adapt to ongoing shifts in demographics, consumer demand and industry trends. Landlords are investing in mixed-use developments combining retail, entertainment, office and residential uses. While retailers have traditionally demanded standalone space with lots of parking, landlords are now being challenged to provide more density. As the sector continues to shift, landlords need to be proactive in meeting with tenants to adjust to their ever-changing needs as they look to replot physical space to meet changing consumer preferences.

Office space seeing strong demand, but company needs are changing as work evolves

Amid ongoing employment growth,[29] competition for high-quality office space is intensifying. The national office vacancy rate declined to 10% from 11.2% in Q3 2019.[30] The sector accounted for 17% of investment volume as of Q3, with 433 transactions registered worth nearly $5.9 billion.[31] New projects under construction totaled 21 million square feet for office, as of Q3, with 13 million square feet already pre-leased.[32] According to CBRE, acquisitions for the office asset class totaled $2.6 billion in Q3,[33] with significant investment being directed to trophy assets.

However, as the nature of work evolves, requirements for office space are shifting and demand is moving toward more modern amenities and building systems, shared spaces and creative office spaces with flexible lease terms. As companies become more dynamic and nimble, they are seeking more flexible, technology-enabled workspaces that support fluctuating headcounts and accommodate differentiated employee experiences. Investors are exploring redevelopment, upgrades and the addition of newer amenities as they look to compete and improve the value-add of their properties.

Flexible office space, in particular, is becoming more mainstream. Growth in the flexible office market has ramped up in recent years, expanding from 1.5 million square feet in 2014 to 6.1 million square feet in 2019, representing an increase of 303%. An additional 1.3 million square feet of flexible real estate is set to open in the coming years.[34]

Alternative asset classes

As they expand their diversification strategies, investors are turning to areas of the property market that may offer better returns but fall outside traditional segments, including non-core markets and alternative asset classes. Highlights from these include:

Seniors housing
With the number of seniors expected to reach over 9.5 million by 2020, accounting for 23% of the Canadian population,[35] there is strong demand for seniors housing.[36] While the trend toward aging in place may mitigate the demand for seniors housing in the short-term,[37] the sheer size of the baby boomer generation will eventually drive heightened need for senior housing and cause shifts in the housing market. However, the market is characterized by high barriers to entry and strict regulations. In addition, it's typically cost prohibitive to try to renovate existing facilities, driving a need for new, purpose-built senior housing that considers the range of health needs and income status of seniors in Canada. Despite a short-term oversupply of seniors housing in certain markets, developers expect an acceleration in the market in 2021 as the so-called Grey Tsunami hits. Despite a short-term oversupply of seniors housing in certain markets, developers expect an acceleration in the market in 2021 as the so-called Grey Tsunami hits.

Developers expect an **acceleration in the market in 2021** as the so-called Grey Tsunami hits

Data centres
Demand for data storage has skyrocketed in recent years, fueled by emerging tech trends and the proliferation of digital technologies. As 5G technology rolls out, demand is expected to increase further. Data centre markets across North America added nearly 200 megawatts of new capacity in H1 2019, with more than 411 MW of capacity under construction and expected to deliver in the near-term.[38] North American data centre investment volume totaled $1.3 billion during the period, according to CBRE.[39] Notably, US-based providers and investors are expanding their presence in Canadian markets, which allows providers to offer clients appropriate data sovereignty.

Going forward, new deliveries are expected to provide a range of features, from managed service offerings and connectivity options to flexible deal structure. There's an opportunity for providers to offer bandwidth to tenants by incorporating high levels of connectivity and heavy fiber from rail corridors into adjacent commercial tenanted buildings. Integrated solutions that move beyond simply providing enterprise wholesale solutions to tap into ancillary revenue streams and implement new technologies will emerge.

Student housing

As the student population grows, interest in purpose-built student housing accommodation is growing. According to JLL, the purpose-built student accommodation sector has grown markedly since 2011[40] as finance permeates niche real estate sectors.

Development of student housing also gives real estate businesses the opportunity to more easily acquire customers for their up-market apartment products, once students have completed their studies and are entering the workforce. This can be a unique chance to build trust and offer value for companies that might typically operate in the multi-family space.

Co-living spaces

According to JLL, global funding for co-living has grown by more than 210% annually, reaching US$3.2 billion, as housing costs increase.[41] The sector has transformed from a small group of apartments with common areas to an asset class of its own, with amenities similar to conventional Class-A multi-family or student-housing sectors. The trend is linked to housing affordability, with operators expanding in cities where average rents are trending above average incomes.

Canada has seen smaller start-ups and operators experimenting with the model, but large developers are just starting to enter the space here[42] and beginning to launch projects across the country[43] as housing and apartment rents increase. To date, most major co-living companies have yet to enter the Canadian market.[44] There's no standard model for shared living space in Canada, but significant opportunities for a return on investment should one be developed, as affordability and density will drive demand for co-living in the country.

Innovation, tech and real estate

Smart technology is increasingly being leveraged to help landlords and companies optimize the use of space, improve the tenant experience and promote energy and financial savings. New construction more often includes new smart building technologies, which in turn allows landlords to request higher leasing fees. With artificial intelligence increasingly being leveraged to control buildings to the maximum extent possible, accurate data is also gaining importance.

At the same time, real estate companies need to carefully weigh the impact of new technology versus costs, as keeping pace with all technological change could prove to be a trap if the economics don't change. Real estate companies also need to be cognizant of the heightened cybersecurity and privacy risks.

Looking out for your future

Today's real estate sector is being driven by both internal and external market forces, and it's essential for developers, investors, builders and others working in the industry to understand how trends can create new opportunities, as well as risks. At Grant Thornton, our team is monitoring what these trends could mean for your business and assessing how you can maximize your growth potential. Contact us to learn more.

Sources

1 International Monetary Fund, October 2019. "World Economic Outlook." https://www.imf.org/en/Publications/WEO/Issues/2019/10/01/world-economic-outlook-october-2019

2 International Monetary Fund, October 2019. "World Economic Outlook." https://www.imf.org/en/Publications/WEO/Issues/2019/10/01/world-economic-outlook-october-2019

3 Financial Post, January 13, 2020. "Global debt-to-GDP ratio has now hit an all-time high of 322%," by Alex Tanzi. https://business.financialpost.com/news/economy/global-debt-to-gdp-ratio-hit-an-all-time-high-last-year

4 Statistics Canada, November 29, 2019. "Gross domestic product, income and expenditure, third quarter 2019." https://www150.statcan.gc.ca/n1/daily-quotidien/191129/dq191129a-eng.htm

5 The Canadian Press, December 4, 2019. "Bank of Canada holds interest rates steady." https://www.cbc.ca/news/business/bank-of-canada-interest-rates-1.5383640

6 Altus Group. "Snapshot: Investment Trends – Q3 2019." https://datasolutions.altusgroup.com/snapshot-investment-trends-q3-2019/

7 Altus Group, "National Investment Transaction Stats – Q3 2019." https://datasolutions.altusgroup.com/national-investment-stats-q3-2019/

8 Altus Group, "National Investment Transaction Stats – Q3 2019." https://datasolutions.altusgroup.com/national-investment-stats-q3-2019/

9 CBRE, Q3 2019. "Investment volumes top $10.0 billion for second straight quarter." https://www.cbre.ca/en/research-and-reports/Canada-Investment-MarketView-Q3-2019 (see full report)

10 CBRE, Q3 2019. "Investment volumes top $10.0 billion for second straight quarter." https://www.cbre.ca/en/research-and-reports/Canada-Investment-MarketView-Q3-2019 (see full report)

11 Reuters, November 22, 2019. "Canada housing market bounding back, but not to boom times: Reuters poll," by Mumal Rathore. https://ca.reuters.com/article/idCAKBN1XW15E

12 Immigration Canada, October 1, 2019. "Record Canada Population Growth Dominated By Immigration." https://www.immigration.ca/record-canada-population-growth-dominated-by-immigration

13 Statistics Canada, November 29, 2019. "Gross domestic product, income and expenditure, third quarter 2019." https://www150.statcan.gc.ca/n1/daily-quotidien/191129/dq191129a-eng.htm

14 Altus Group, "National Investment Transaction Stats – Q3 2019." https://datasolutions.altusgroup.com/national-investment-stats-q3-2019/

15 The Canadian Press, October 24, 2019. "CMHC expects housing market to recover in next 2 years after declines." https://www.cbc.ca/news/business/cmhc-housing-market-recovery-two-years-1.5333503

16 Royal LePage, December 12, 2019. "Canadian real estate market to appreciate 3.2% in 2020 reflecting similar price growth in both condo and detached segments." https://www.newswire.ca/news-releases/canadian-real-estate-market-to-appreciate-3-2-in-2020-reflecting-similar-price-growth-in-both-condo-and-detached-segments-819344611.html

17 Canadian Real Estate Forums, "Top 10 Real Insights: 2019 Toronto Real Estate Forum, Issue 37" https://www.realestateforums.com/content/dam/Informa/realestateforums/2019/portal/RealInsights/37-RealInsights-TREF19-Final.pdf

18 CBRE, September 3, 2019. "CBRE Report: Canada's Multifamily Market is the Strongest it's Ever Been." https://www.cbre.ca/en/about/media-center/cbre-report-canadas-multifamily-market-is-the-strongest-its-ever-been

19 CBRE, Q3 2019. "Investment volumes top $10.0 billion for second straight quarter." https://www.cbre.ca/en/research-and-reports/Canada-Investment-MarketView-Q3-2019 (see full report)

20 CBRE, Q3 2019. "Investment volumes top $10.0 billion for second straight quarter." https://www.cbre.ca/en/research-and-reports/Canada-Investment-MarketView-Q3-2019 (see full report)

21 CBRE, Q3 2019. "Investment volumes top $10.0 billion for second straight quarter." https://www.cbre.ca/en/research-and-reports/Canada-Investment-MarketView-Q3-2019 (see full report)

22 Altus Group. "National Office & Industrial Market Update – Q3 2019." https://datasolutions.altusgroup.com/national-office-industrial-market-update-q3-2019-2/

23 Altus Group. "National Office & Industrial Market Update – Q3 2019." https://datasolutions.altusgroup.com/national-office-industrial-market-update-q3-2019-2/

24 Altus Group. "National Investment Transaction Stats – Q3 2019." https://datasolutions.altusgroup.com/national-investment-stats-q3-2019/

25 Altus Group. "National Investment Transaction Stats – Q3 2019." https://datasolutions.altusgroup.com/national-investment-stats-q3-2019/

26 CBRE, Q3 2019. "Investment volumes top $10.0 billion for second straight quarter." https://www.cbre.ca/en/research-and-reports/Canada-Investment-MarketView-Q3-2019 (see full report)

27 Altus Group. "National Investment Transaction Stats – Q3 2019." https://datasolutions.altusgroup.com/national-investment-stats-q3-2019/

28 CBRE. December 3, 2019. "Lenders Are Feeling Bullish About Canadian Real Estate in 2020." https://www.cbre.ca/en/about/media-center/lenders-feeling-bullish-about-canadian-real-estate-in-2020

29 Statistics Canada, January 10, 2020. "Labour Force Survey, December 2019." https://www150.statcan.gc.ca/n1/daily-quotidien/200110/dq200110a-eng.htm

30 Altus Group. "National Office & Industrial Market Update – Q3 2019." https://datasolutions.altusgroup.com/national-office-industrial-market-update-q3-2019-2/

31 Altus Group. "National Investment Transaction Stats – Q3 2019." https://datasolutions.altusgroup.com/national-investment-stats-q3-2019/

32 Altus Group. "National Office & Industrial Market Update – Q3 2019." https://datasolutions.altusgroup.com/national-office-industrial-market-update-q3-2019-2/

33 CBRE, Q3 2019. "Investment volumes top $10.0 billion for second straight quarter." https://www.cbre.ca/en/research-and-reports/Canada-Investment-MarketView-Q3-2019 (see full report)

34 CBRE, Q3 2019. "Investment volumes top $10.0 billion for second straight quarter." https://www.cbre.ca/en/research-and-reports/Canada-Investment-MarketView-Q3-2019 (see full report)

35 Government of Canada, Fall 2014. "Action for Seniors report." https://www.canada.ca/en/employment-social-development/programs/seniors-action-report.html

36 Government of Canada. "Report on housing needs of seniors." https://www.canada.ca/en/employment-social-development/corporate/seniors/forum/report-seniors-housing-needs.html

37 CMHC, May 31, 2019. "CMHC Releases Annual Review of Seniors' Residences Market." https://www.cmhc-schl.gc.ca/en/media-newsroom/news-releases/2019/cmhc-releases-annual-review-seniors-residences-market

38 CBRE, HI 2019. "North America Data Center Trends H1 2019." https://www.cbre.us/research-and-reports/North-America-Data-Center-Trends-H1-2019

39 CBRE, HI 2019. "North America Data Center Trends H1 2019." https://www.cbre.us/research-and-reports/North-America-Data-Center-Trends-H1-2019 (see full report)

40 Sage Journals, November 20, 2019. "Making a market for itself: The emergent financialization of student housing in Canada," by Nick Revington and Martine August. https://journals.sagepub.com/doi/abs/10.1177/0308518X19884577?journalCode=epna&

41 JIl, June 17, 2019. "Why investors are signing up for coliving." https://www.JIl.ca/en/trends-and-insights/investor/why-investors-are-signing-up-for-coliving

42 BNN Bloomberg, June 24, 2019. "A dorm with pub crawls, only fancier: Co-living comes to Canada," by Natalie Wong. https://www.bnnbloomberg.a/a-dorm-with-pub-crawls-only-fancier-co-living-comes-to-canada-1.1277601

43 Yahoo Finance Canada, August 8, 2019. "Co-living has arrived in Canada amid affordability crunch," by Alicja Siekierska. https://ca.finance.yahoo.com/news/coliving-has-arrived-in-canada-amid-an-affordability-crunch-181355041.html

44 CBRE. "Co-living comes to Canada." https://www.cbre.ca/en/about/advantage-insights/articles/industry-trends/co-living-has-arrived-in-canada-now-what

45 Grant Thornton, April 3, 2019. "Smart buildings: Moving beyond green for added value." https://www.grantthornton.ca/insights/smart-buildings-moving-beyond-green-for-added-value/

Grant Thornton

Audit | Tax | Advisory

About Grant Thornton LLP in Canada

Grant Thornton LLP is a leading Canadian accounting and advisory firm providing audit, tax and advisory services to private and public organizations. We help dynamic organizations unlock their potential for growth by providing meaningful, actionable advice through a broad range of services. Grant Thornton LLP is a Canadian member of Grant Thornton International Ltd, whose member and correspondent firms operate in over 100 countries worldwide.