DECEMBER 2022

The Uncertain Future of the Canadian Office Market

Why the Office Sector Dramatically Changed

When COVID-19 emerged and the World Health Organization declared the outbreak a "Pandemic" on March 11, 2020, the world instantly changed. The global economy came to a screeching halt via government-mandated lockdowns and, out of necessity, the world's service workers pivoted immediately to a work-from-home ("WFH") model.

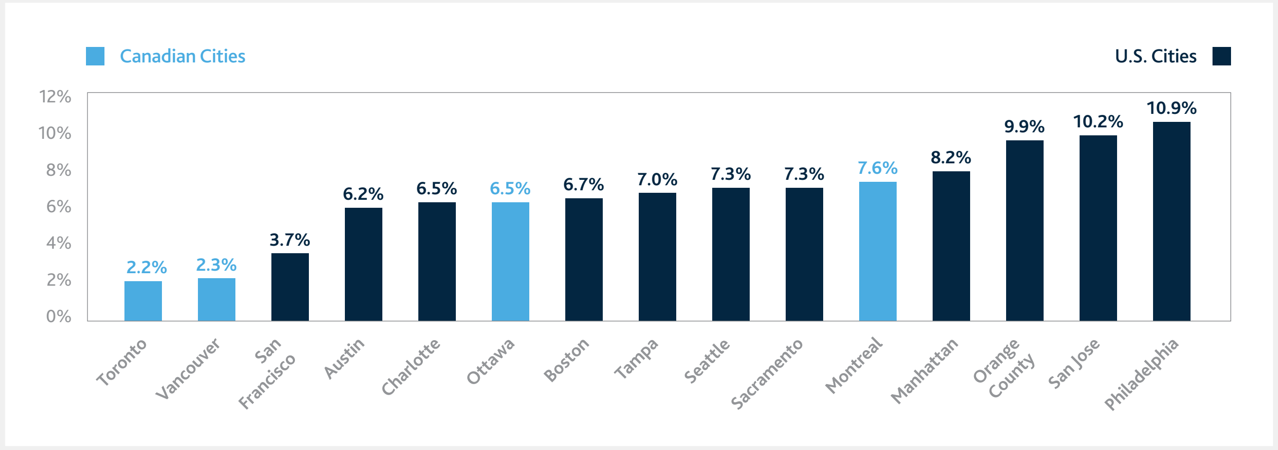
The goods and manufacturing sectors were unable to WFH given the physical presence of labour and equipment needed to produce these goods; however, participants in the services sector quickly discovered they were able to be productive and collaborate through advanced technology communication platforms. This ability to digitally work on a home computer and avoid the analog "pre-COVID" world hassles of commuting to work on crowded routes, paying for dry cleaning, buying lunch out, etc., led many employees and employers to ask themselves the question, "**Is this a better way?**" Nearly three years since the Pandemic began, the global services sector is still trying to determine a suitable response to this question, which, no doubt, will ascribe a large question mark to the fate of the office market.

How the Canadian Office Market Has Been Impacted

Canada: North American Office Stalwart

Heading into the Pandemic, Canada's downtown office markets boasted some of the tightest downtown office fundamentals in North America. As at Q4 2019, Toronto and Vancouver took the top market spots at 2.2% and 2.3% vacancy rates, respectively.[1]

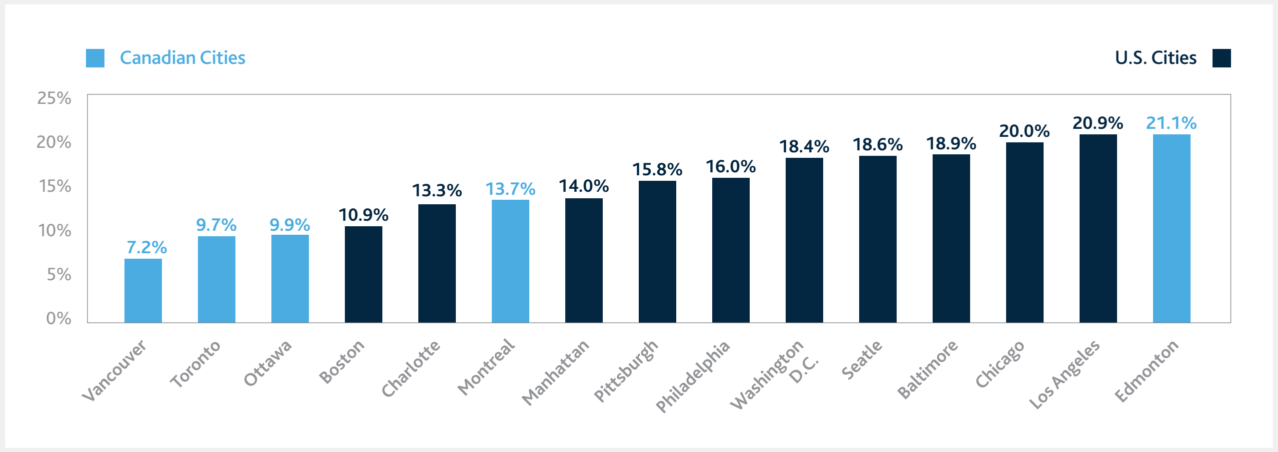
Downtown Office Vacancy Rates – Q4 2019



Source: CBRE Research, Q4 2019

Fast forward two years to Q4 2021 and one will notice that Canadian downtown office markets were still dominating the podium, but at much higher vacancy rate levels.[1]

Downtown Office Vacancy Rates – Q4 2021



Source: CBRE Research, Q4 2021

The rapid rise in vacancy rates was largely attributed to negative net absorption as employers shed space during the sharp economic slowdown of the Pandemic and grappled with what their future office needs would look like.

1. https://www.cbre-ea.com/data/iprojects

Fundamental Bifurcations Between Office Segments

Quality Bifurcation

As expected, higher quality buildings (Class 'A' or above) that are more functional, desirable, and adaptable are outperforming, reflecting more resilient vacancy rates than the total Canadian office market.[1]

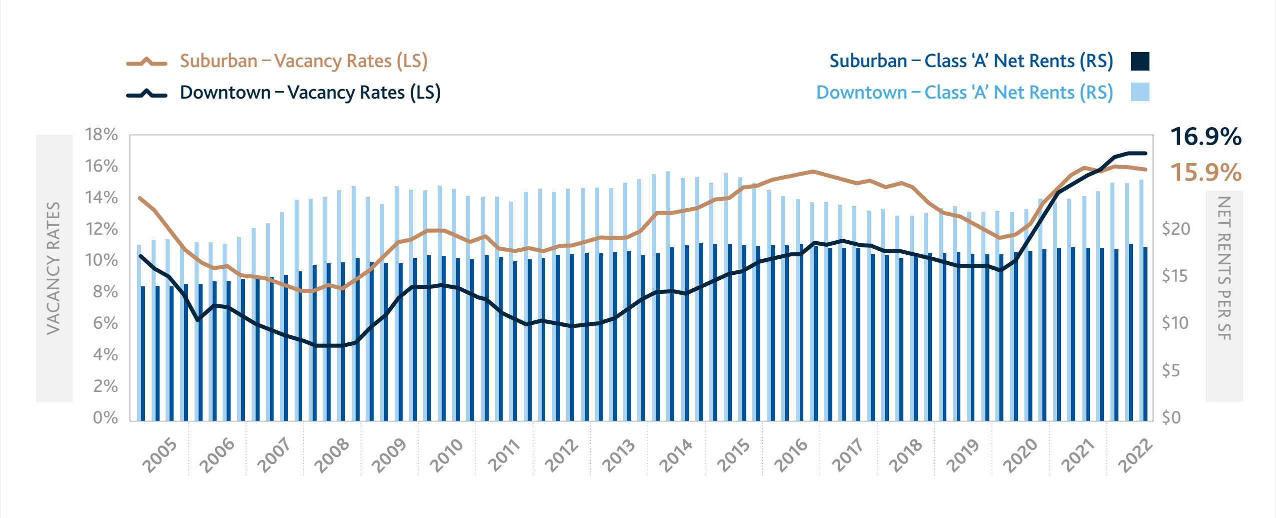
Q3 2022	Class 'A' or Above	Below Class 'A'	Total Office Market
Vacancy Rate	15.2%	18.1%	**16.4%**

Source: CBRE Research

Location Bifurcation

Another interesting trend is that for the first time, the national vacancy rate for downtown offices has risen above the suburban equivalent[1] as shown on the graph below:

Canadian Office Market Fundamentals by Location

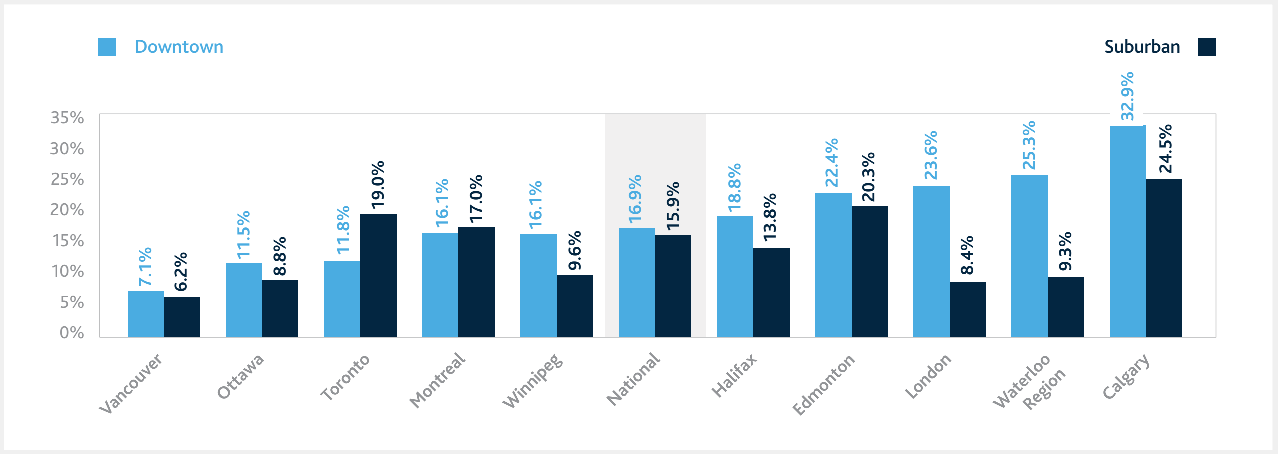


Source: CBRE

1. https://www.cbre-ea.com/data/iprojects

To assess breadth, on a city-by-city cross-section of the country, eight out of ten cities now have downtown vacancy rates higher than suburban vacancy rates.[2] By simply extrapolating these trends, downtown office buildings that are not considered functional or adaptable to current trends and not in prime locations are being impacted most adversely.

Downtown vs. Suburban Office Vacancy by Market



Source: CBRE Research, Q3 2022

1. https://www.cbre-ea.com/data/iprojects
2. https://www.cbre-ea.com/docs/default-source/iprojects/statistical-summaries---quarterly/canada_quarter_stats_-_2022_q3.pdf?sfvrsn=2

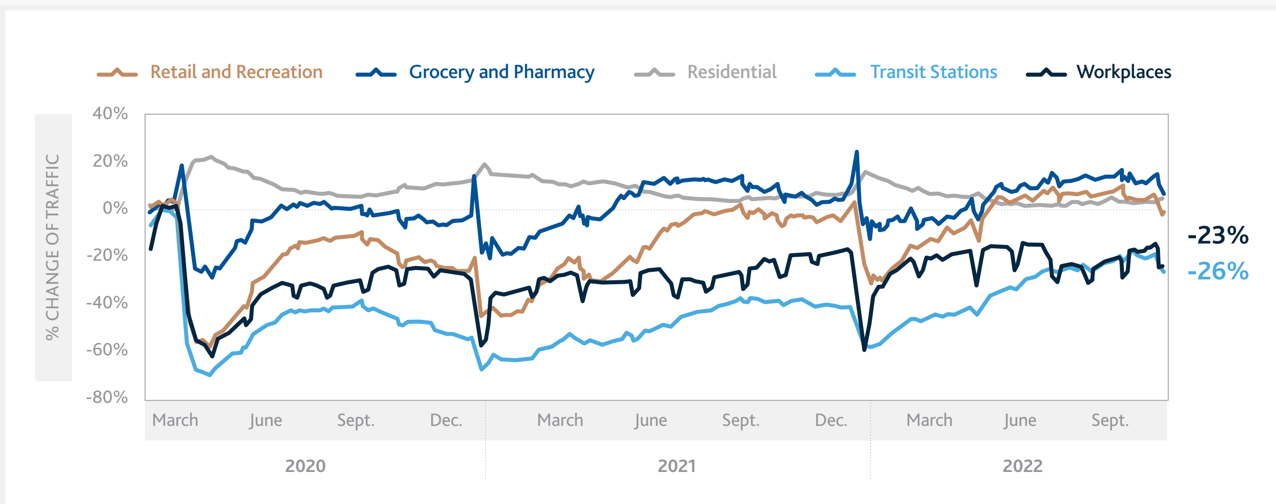
What Is the New Normal for Office Utilization?

Looking ahead, the question remains whether the Pandemic has changed work habits and business models temporarily, or is this permanent and a *structural* shift?

Employee Behavioural Changes

According to Google's mobility trends[3] (graph below), it appears the ratios of people traffic to **"Workplaces"** (black line) and "**Transit Stations**" (light blue line) have been recently improving relative to the depths of the Pandemic. Improvement is encouraging; however, both categories are still 23-26% below their pre-Pandemic levels.

Google Mobility Trends: Changes in Foot Traffic



Source: ourworldindata.org/covid-google-mobility-trends

Reinforcing this finding is an American company called Kastle Systems that provides leading managed security to over 10,000 companies globally. Its "Barometer" based on daily access data from 41,000 businesses nationwide shows only 45% of office entry as a percentage of 2019 activity.[4] Put another way, there are 55% fewer service sector employees signing into and out of offices compared to pre-Pandemic levels.

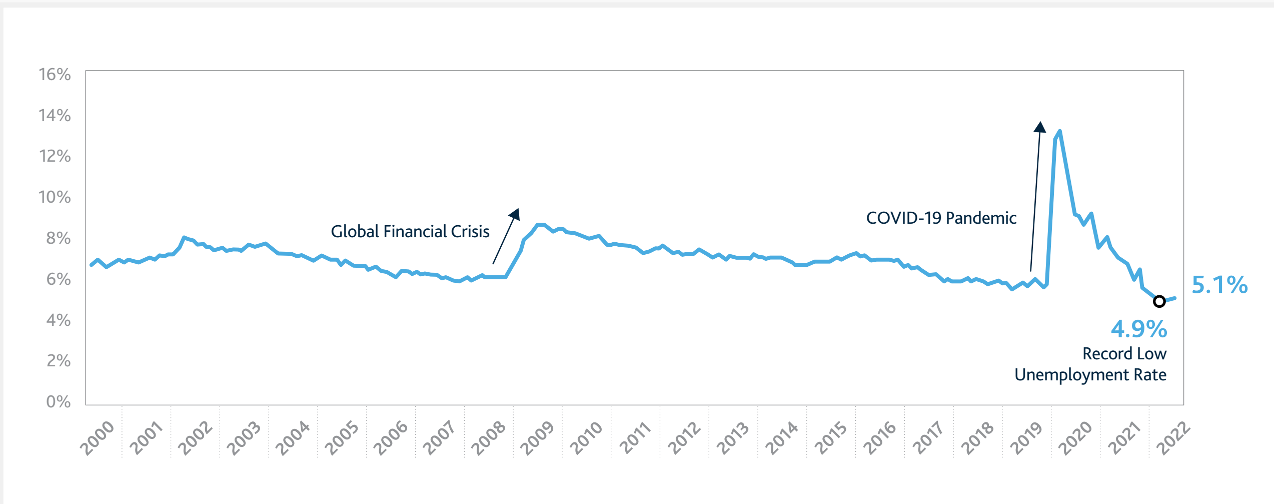
If office traffic has still not recovered to levels seen nearly three years ago before the Pandemic began, it is fair to assume that this trend of reduced employee activity in the office is ***structural***, or has further staying power.

3. https://ourworldindata.org/covid-google-mobility-trends
4. https://www.kastle.com/safety-wellness/getting-america-back-to-work-recreation-vs-office-occupancy/

Employer Behavioural Changes

According to a recent survey by Jones Lang LaSalle (*The Future of Work Survey 2022*),[5] as companies emerge from the crisis created by the Pandemic, they now face new and critical challenges. Among the most important of these challenges is managing through a tight job market that has shifted power from the employer to employee. This is supported by Canada's latest unemployment rate of 5.1% in November, 0.2% higher than its record low 4.9% in July 2022, as shown in the graph below:

Canada's Unemployment Rate %



Source: Statistics Canada

Given Canada's aging population and the early exodus of Baby Boomers from the workforce, the working age population (aged 25-64 years old) is highly likely to shrink relative to total population share, compared against the last few decades. A structurally tighter job market is already becoming an increasingly concerning force as organizations are being compelled to compete even harder on benefits and compensation, as well as offer flexible working options to attract and retain talent. Ultimately, this dynamic is leading to a reimagination of the workplace from an employer perspective and re-vamped real estate investment strategies from an office landlord standpoint. Notable as well is the increased investment required in office-based communication technology applications to facilitate collaboration across many different locations (including WFH), which is becoming vital to boosting performance levels on all fronts.

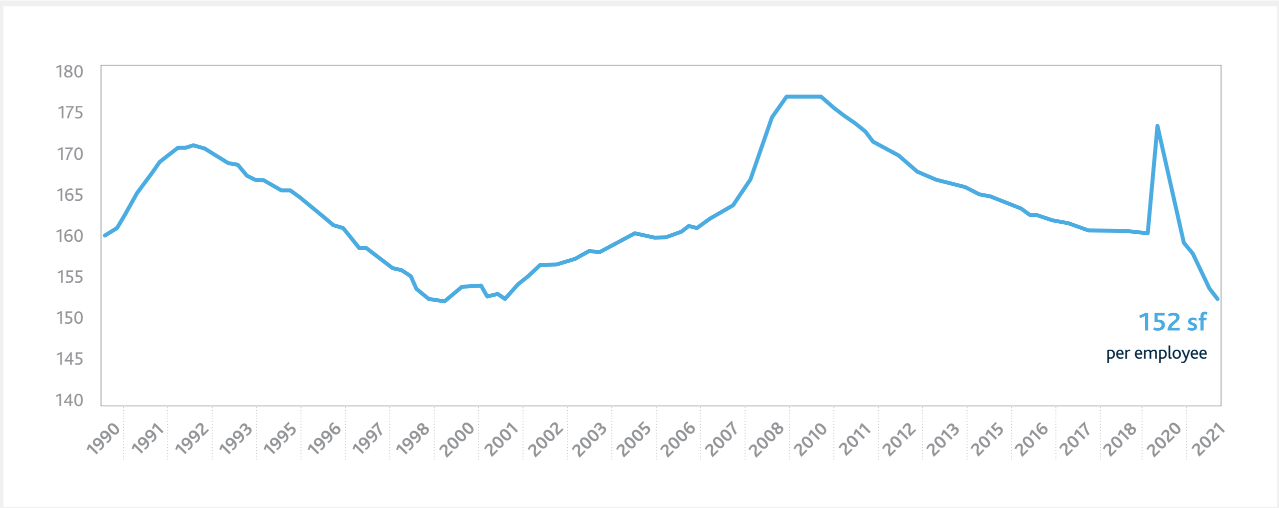
Employers are realizing that hybrid work models are now a ***structural*** reality and adapting to these new dynamics will be a key differentiator for success.

5. https://www.jll.ca/content/dam/jll-com/documents/pdf/research/global/jll-future-of-work-survey-2022-v1.pdf
6. https://www150.statcan.gc.ca/n1/daily-quotidien/220805/dq220805a-eng.htm?HPA=1&indid=3587-2&indgeo=0

Evolving Office Space Per Employee

Office tenants are grappling with another uncertainty – the utilization of space and striking the right balance of office space per employee. The amount of office space a company leases is an indicator not only of near-term space usage, but future growth expectations. According to CBRE,[7] prior to 2008, corporate office footprints were growing, driven by higher per employee space allocations and the leasing of excess space in anticipation of future growth. Since 2009, square feet per employee have steadily declined. This is attributable primarily to densification strategies that existed in most corporate premises cost reduction plans coming out of the Global Financial Crisis. There was a similar dynamic in the mid-1990s as the economy was recovering from recession.

Occupied Square Feet per Office-Using Employees



Source: CBRE

Despite speculation that the Pandemic's social distancing requirements would boost per employee space allocations, that evidence has yet to embed itself in the data. With the shift to hybrid work, using the above U.S. data as a proxy for Canada, the current space per employee has fallen nearly 5% from already lean pre-Pandemic levels to 152 square feet – representing a low not seen since the turn of the century. Intuitively, "hoteling" or desk sharing strategies may be partially explaining these lower space requirements per employee.

Leaner office footprints can produce significant cost savings for employers, but often leave minimal room for future growth. Given the current economic uncertainty and seemingly weaker office fundamentals, it appears employers believe additional future space will be available at attractive rents, if and when needed.

7. https://www.cbre.com/insights/adaptive-spaces

The Demand and Supply Equation Going Forward

The Demand Side

What are the implications of potentially having significantly less people in an office on any given day?

Assuming a range of the Google Mobility trends (~25% less) and the Kastle Barometer for workplace activity (~55% less), employee utilization will be roughly 35% lower at workplaces going forward. For the purposes of this report, this decline will be labeled as the 35% "WFH Impairment".

Next, to determine future service sector job demand growth, Canada's current job composition to the services sector represents approximately 80% of total employment and is highly correlated to office absorption. According to Statistics Canada, 19.7 million people were employed in Canada as of November 2022.[8] Assuming the 80% service sector jobs ratio remains stable over the next five years and then applying the Conference Board of Canada's national total employment forecast of 20.2 million,[9] this implies that 400,000 new service sector jobs will be added.

On a space per employee basis, it is reasonable to assume the current metric of 152 square feet per employee remains stable given employers running leaner footprints for desks, offset by demand for more collaborative space.

Therefore, to arrive at demand for space related to new service jobs, if the 400,000 new service sector jobs were multiplied by the 152 square feet per employee, it would equal 61 million square feet of net new demand over the next five years. Then assuming the WFH Impairment relationship holds, that 61 million square feet of absorption can be reduced by 35% to 40 million square feet.

Office Space Demand Over Next 5 Years

Forecasted Employment Growth	500,000
Service Sector Composition	x 80%
Service Sector Employee Growth	400,000
Office square feet (SF) per employee	x 152 SF/employee
Service Sector SF	= 61 million
Reduced for WFH Impairment (35%)	(21 million)
Office SF Demand	**40 million**

Source: Conference Board of Canada national employment forecast

8. https://www150.statcan.gc.ca/n1/daily-quotidien/221202/dq221202a-eng.htm?lnk=dai-quo&indid=3587-1&indgeo=0
9. https://www.conferenceboard.ca/focus-areas/canadian-economics/major-city-insights/11067

The Supply Side

Given the uncertainty and risk of developing new office product, it can be fairly assumed that practically no new speculative office buildings will be undertaken over the next five years and only projects currently under construction will be added to Canada's national office inventory. Looking at CBRE's Q3 2022 total Canadian office inventory provides a figure of 485 million square feet. Current vacant space (80 million square feet) and existing space under construction (13 million square feet) adds to roughly 93 million[10] of available supply. This conservatively assumes the current tenant base will not downsize space upon its lease renewal, as has been the dominant trend since the Pandemic.

Office Space Supply Over Next 5 Years

Current Inventory – SF	485 million
Current Vacancy	x 16.4%
Current Vacancy / Availability – SF	80 million
Add: New Construction	+ 13 million
Availability over Next 5 Years	**93 million**

The Resultant Equation

So, what does this all mean?

Given all the assumptions and figures above, Canada's national office vacancy of 16.4% should be reduced to a more balanced 10.6% in five years (53 million vacant square feet of 498 million total inventory square feet).

(SF)	Current	New Construction	Absorption / New Demand	Anticipated Vacancy
Inventory	485 million	13 million	–	498 million
Availability	80 million	13 million	(40 million)	53 million
Vacancy	**16.4%**	–	–	**10.6%**

10. https://www.cbre-ea.com/docs/default-source/iprojects/statistical-summaries---quarterly/canada_quarter_stats_-_2022_q3.pdf?sfvrsn=2

Generous assumptions have been made that apply the 35% WFH Impairment to *only* newly absorbed space, and, given the longer-term nature of office leases, as more active leases mature post-Pandemic, further evidence of potential renewal demand decreases may be exposed. **Therefore, this may be *a best-case scenario* for the office market, and, if it happens, even a move from 16.4% to 10.6% vacancy is unlikely to result in any meaningful rental rate growth due to excess space options for tenants.**

Realizing there are many assumptions made here, the potential path to getting back to a balanced market is bracketed by a wide dispersion of outcomes – especially with central banks tightening monetary policy and a likely economic recession to be experienced. From a current investment perspective, the office market is likely poised for downward repricing, but again, not all segments or properties will be impacted in the same way. Downtown Class 'B' or lower quality buildings are likely to feel a disproportionately significant brunt of this price discovery and suburban office may even enjoy a period of outperformance relative to downtown. Ultimately, however, Class 'A' office facilities with greater adaptability, flexibility to create more collaborative spaces, and in locations near irreplaceable transit and infrastructure should remain coveted, as they were prior to the Pandemic.

Concluding Thoughts

Despite the wide range of highly speculative assumptions required to assess the office sector's health as best as one can, there undeniably is an element that can be assessed with certainty – the next five years for the Canadian office market will look strikingly different than the previous five years. Canada's office market will undoubtedly evolve to meet the future needs of Canadian corporations, as the retail sector has done over many years and cycles; however, there remains exceptional uncertainty for the office sector and the path through that evolution is, at best, unclear.

Owners able to best determine which behavioural trends are structural rather than temporary and can execute adaptive strategies to capitalize on these trends will be best positioned for future outperformance in the office sector.

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