

Commercial real estate sector faces a complex outlook

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The economic and financial outlook has rarely been as uncertain as it is today. The legacy of COVID-19, the conflict in Ukraine, skyrocketing oil prices, spreading inflationary pressures and rising interest rates make a complex cocktail of risk for everyone, but especially for commercial real estate.

Two years ago, as the full reality of the COVID-19 pandemic was just becoming clear, economists were justifiably concerned that a repeat of the Great Depression of the 1930s could be in the cards. Good policymaking averted that painful scenario. But shutting an economy down and then starting it up again turns out to be more difficult than it sounds.

By the fall of 2020, the economy had already recovered to between 97–98% of where it was prior to the pandemic. Conditions were very difficult for the 2% economy, to be sure, but the 98% economy was not just playing defense: it was growing, adding new jobs throughout the pandemic. These jobs included a wide range of professional services spanning IT, legal, engineering, medical and personal care. As it happens, some unemployed people from the 2% economy managed to find their way into the 98% economy, with the result that re-opening the 2% has been confronted with a widespread shortage of workers.

The situation therefore presents a risk of rising home-grown inflation, as distinct from international inflation. International inflation pressures began to emerge in early 2021, mainly because sporadic shutdowns around the world were causing supply chain issues that boosted prices for many goods. There was every reason to expect these pressures to subside by mid-2022, but that expectation was shattered by the Russian invasion of Ukraine and the steep rise in commodity prices it has engendered.

Now, the dominant policy concern has shifted to inflation, especially the risk that international inflation could become embedded in domestic inflation, and the range of consequences that efforts to contain inflation by the world's central banks might lead to. These include a much higher profile for interest rates and slower economic growth — perhaps even a recession — and therefore a period of stagflation. In short, the near-term real estate outlook has shifted significantly in a very short time.

Adding to the uncertainty are the structural changes that are occurring beneath the surface of the economy. The most important legacy of the pandemic will be the discovery that so much of what we do can be done remotely, given the right tools. This realization, and the

general worker shortage, is shifting market power from the employer to the employees. Companies are still sorting out how much floorspace they will need once they find a new balance between working from home, working from the office and social distancing requirements. How many workers must be present to ensure operational needs are met? How many days per week will other employees come to the office? When they do, will they expect to have their usual space, or will they accept a rotational workspace arrangement? How do we accommodate the entire group of employees if they all appear on the same day? And how do we re-create the conditions for teamwork, mentoring and synergy-generation that drive innovation in the firm? The answers to these questions will vary by firm, especially between growing firms and static firms, and they will have profound implications for the demand for office space, especially in the downtown core.

The answers to these questions will also determine the level of downtown foot traffic on any given day. Accordingly, they will spill over onto a variety of other support businesses — restaurants, bars, food courts, retail merchants, dry cleaners, gyms, hair stylists. The list of those affected is very long. In the case of retail, much of the shift during the pandemic toward online purchasing could prove permanent, perhaps leading to growing demand for warehouse or fulfillment (last mile) space. If workers will be spending a higher percentage of their time in their home neighbourhood, and less downtown, an entirely new balance of commercial space and tenants may need to emerge. This may also alter the parameters around transportation infrastructure — roads, bridges and public transit.

Even so, higher immigration could still overwhelm all these factors, at least in some cities. It is expected that Canada's population will continue to grow at a rate more than 1% per year. Immigrants tend to settle in our major cities, adding to the demand for both rented and owned housing. They create new businesses, adding to the demand for commercial real estate. And, of course, they add to downtown foot traffic, potentially mitigating many of the factors mentioned earlier that could reduce it.

Adding it all up, the net effect on landlords is simply too complex to forecast. The long-term outlook for commercial real estate appears positive, on balance, because the economy starts from a strong place, any slowdown induced to manage inflation pressures ought to be brief and shallow, and steady population growth should put a floor under the sector. However, the potential for extreme volatility remains elevated, as evolving demographics interact with a wave of new technology and growing political polarization. The risk of higher or more variable inflation will persist long after the current episode related to events in Ukraine. Housing demand looks likely to continue to strain the supply system, and while some firms will decide that they need less office space, new firms and growing firms will need more.

Given all this, asking what the outlook is for commercial real estate may be asking the wrong question. Perhaps we should be asking ourselves not what economic scenario is most likely, but what range of economic scenarios should we be prepared for? Based on today's situation, it seems we should be prepared to weather a period of higher inflation, perhaps a recession, higher interest rates, and persistent growth in base demand coming from immigration flows. The outcomes could vary greatly from city to city. Being prepared for volatility means primarily building flexibility into the business plan, both financial and real. Financial resilience requires carrying a capital buffer that allows a landlord to weather a storm, or to capitalize on a positive development. Real resilience means maintaining a business plan that can be altered readily. One direction that seems likely is an increased use of mixed-use buildings, whether new or retrofit. A building that can transition from 100% commercial to 80% commercial and 20% residential, and then to 70/30 and then back again, would be far more valuable than one that cannot transition in this way. Managing red tape around such a strategy could become a core occupation for landlords and developers.

The bottom line? Economic and financial uncertainty is elevated today, but it could rise even further during the next five to 10 years. The balance of risks remains positive for the

commercial real estate sector, mainly because immigration into Canada is likely to put a floor under the market. But the actual mix of outcomes could vary tremendously, which argues for maintaining as much flexibility as possible on the supply side. As for investors, real estate is likely to remain a popular hedge against high or variable inflation in the years ahead.