cmls

November 2024

Commercial mortgage commentary

Office market in the new rate cut era

As we discussed in Q1, the office market was ready for a comeback (if not a mild one) on what at the time was the anticipation of rate cuts to come. Since then, there have been 4 rate cuts totaling 125 bps. With the lowering of Bank of Canada rates, we have observed some cautious optimism in the office sector.

Outside of lower interest rates, the optimism is being driven by additional dynamics playing out regionally and across Canada including continued efforts towards return-to-office ("RTO"). What we will explore below is that while certain assets might be doing well on recent positivity, others are struggling to find their footing.

A closer look at Ontario: Some markets are struggling, some are excelling

Within Toronto Avison Young reported that Midtown, Toronto East, and Toronto North all experienced declines in vacancy through Q2 while Downtown and Toronto West market vacancy continued to inch up. The strength of suburban markets is prevalent across Canada as CBRE Q3 2024 Canada Office Figures reported that suburban office vacancies have declined for five consecutive quarters. In the same report, CBRE noted that downtown vacancies remain unstable as A- and B-class offices continue to struggle in contrast to the strength of AAA assets.

Further support for suburban strength is shared by CoStar, which reported that as of Q3 2024 the overall vacancy for the Greater Golden Horseshoe was only 4.24%, down slightly QoQ.

This would indicate that on average the suburbs and secondary markets surrounding Toronto are outperforming downtown where vacancy remains ~13%. The same could be said for Vancouver as well where markets like Burnaby and Surrey are outperforming downtown Vancouver (Colliers). Notably, despite the higher vacancies in downtowns these core markets are where interest is growing most with lenders, where there was previously none.

Diving deeper into a few suburban examples, we have the tale of two cities, Waterloo and London, ON. Waterloo is beginning to find its footing as vacancy now sits at 13.5%, down 40bps QoQ. Waterloo's performance is an example of how a secondary market's unique strength can lead to success. Much of the positive absorption that Waterloo has experienced has been in education and medical office buildings that draw on the strengths of the city's universities (CBRE). Another likely factor is Waterloo's position as a tech-hub, attracting startups and other users for smaller turn-key spaces. London on the other hand is still struggling.

London would be a good example of a market that is going to need to explore unique ways of repurposing their existing office stock. As of Q3 2024 London's vacancy rate was still rising, up QoQ to 25.7% as per CBRE London Office Figures, on the back of 5 consecutive quarters of negative absorption.

One example may be leveraging the recently passed Bill 60 in Ontario, which introduced Integrated Community Health Services Centres (ICHSCs), opening a new source of funding for private healthcare businesses. With a little bit of repositioning and/or rezoning this could create opportunities for owners to leverage Southern Ontario's aging population by repositioning their assets towards this new medical office-use which is in growing demand. This could be an enormous opportunity for a market like London to solve both a societal need and reduce office vacancy.

A rising (falling) tide (rate) lifts all ships

Despite some markets performing better than others, the recent rate cuts will have benefits to the whole office market, the first of which is lowering of borrowing costs. The lowering of all-in rates will help facilitate the refinancing of office properties, lowering the systemic risk in the financial system and individual risk for operators, as this could result in fewer defaults. In addition to the BoC rate cuts, CBRE reported that the Canadian office market is "on track for its first year of positive leasing since 2019" which should help boost occupancy levels among office portfolios.

Another continued factor in a recovery is the impact of RTO on the office market. One of the more recent headlines regarding RTO was the mandate for 3 days in office by the Federal Government for all employees (with exceptions) and 4 days for leadership teams (Canada.ca). The push to return to in-person arrangements, while favored by employers, RTO is not without pushback as the Federal Government learned as protests popped up because of this new mandate. Despite the pushback, RTO has the support of the country's largest employers and will continue to be a crucial factor in the rejuvenation of the office market.

The widespread adoption of RTO is picking up and can be seen in markets like Toronto, where there has been an uptick in traffic (The Globe). While commuters hate sitting in traffic, it is a good sign that people are back downtown for the majority of the week. Policy and infrastructure will need to come together to help facilitate the transition back.

Public sector: more space and facilitating re-use

Aside from traditional investment, Canada is seeing more public sector investment shaping the future of office, putting to use the two things they have in abundance: cash and workers.

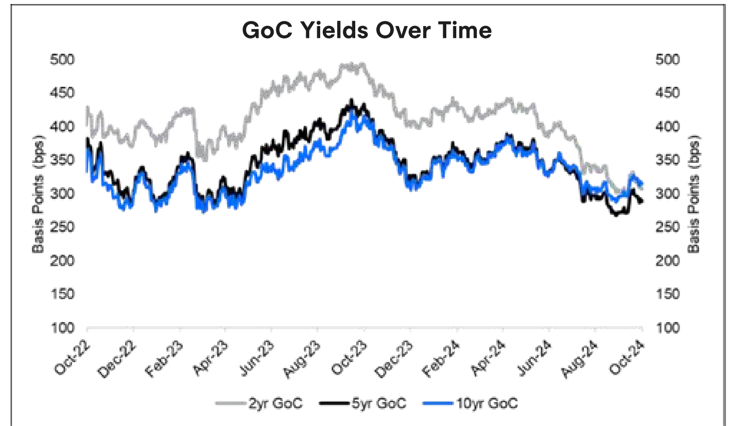
The Ontario provincial government is looking to expand their office footprint with a call to purchase new office space in Toronto. They could be looking to spend up to $100 million on a single 200,000 SF building in the right location. This could attract more workers to the area and provide a nice exit for the would-be vendor. With the Ontario government looking to expand its office footprint, this could be a sign for other provincial and municipal governments trending towards expanding their office footprints as well.

For offices that are still struggling, it is likely they will need to find new relevance or sooner find a wrecking ball. Another option does exist, however, and that includes finding repositioning opportunities to create new housing. Aside from needing more space for themselves, the federal, provincial, and municipal level governments are increasingly taking steps to repurpose underutilized spaces by supporting the conversion of existing office assets and giving them new life as residential housing.

The Apartment Construction Loan Program ("ACLP" or formerly "RCFi") announced in 2021 that the program would initially allow up to $300 million in government funding to be directed towards office-to-residential conversion projects, providing affordable financing in hopes of increasing rental supply throughout Canada. The program no longer has an allocated budget for conversion projects but continues to allow all projects that meet the criteria (including conversions) to be considered for financing. This could be a great exit-option for office operators willing to invest time into repositioning the asset or a willing developer to do the same. Cities like Calgary and Ottawa are already ahead of the trend and are seeing success on conversion projects (e.g. Cornerstone by Astra Group in Calgary & 200 Elgin in Ottawa). Looking closer at Calgary, the successful projects benefitted from subsidized development fees and faster approval timelines, something other cities should take note of. One hope of these conversions is to reduce the total amount of office space, which could benefit the remaining operators by reducing inventory. Other markets across Canada could also benefit from these conversions, not just Calgary and Ottawa.

Sink or swim... or learn to walk?

As the office market reshapes in response to evolving demand, clear frontrunners are beginning to emerge, and lenders are getting off the sidelines to entertain new office lending. Now is a pivotal moment to capitalize on regional strengths, redefine office spaces to meet growing demands—like medical facilities—and explore residential conversions that could balance inventory while enhancing the appeal of remaining office spaces. For operators who adapt strategically, this period presents a unique opportunity to thrive in the face of transformation.



(Bloomberg, 2024)

What's going on with rates?

BoC rate decisions and economic indicators

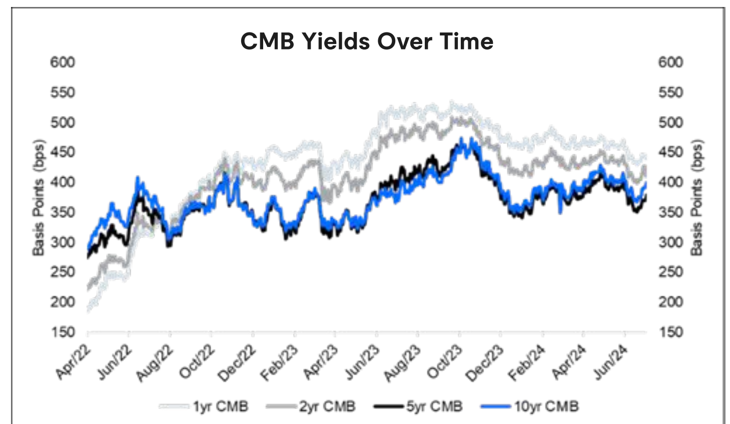
In October 2024, the Bank of Canada (BoC) cut its key policy rate by 50bps from 4.25% to 3.75%, marking the fourth reduction since inflation began rising in 2022. The decision reflects efforts to stimulate growth as inflation fell to 1.6% in September 2024, down from 2.7% in June. Despite this decline, inflation is expected to stabilize around 2%.

Employment growth remained moderate, with 22,000 new jobs added in September (vs the expected 25,000), though the unemployment rate rose slightly to 6.5%. The BoC's rate cut aims to further boost economic activity and ease borrowing costs while keeping inflation close to its target of 2%.

Government bond yields and implications for borrowers

Government bond yields have decreased in relation to the Bank of Canada's recent rate cut. The 5-year Government of Canada (GoC) bond yield has dropped to 3.00%, down from its 52-week high of 4.45% in late 2023. For commercial mortgage borrowers, this decline translates to lower fixed mortgage rates, providing a more favorable borrowing environment. In addition, the GoC yield curve continues to normalize as shorter-term rates fall which will hopefully widen the term premiums to normal levels.

In the third quarter of 2024, Canada Mortgage Bond (CMB) rates continued their downward trend. Despite a sharp increase in October, the 5-year CMB rate finished the quarter at 3.20%, dropping by 30 basis points (bps) QoQ. The 10-year CMB rate trended similarly, adjusting to the latest economic data, and shifting expectations around the Bank of Canada's interest rate policies.



(Bloomberg, 2024)

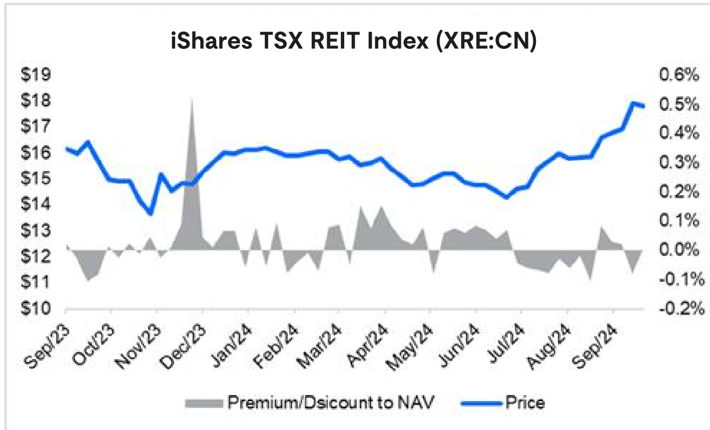
Market sentiment

Financial markets anticipate another 25bps rate cut by the Bank of Canada in December 2024, reducing the implied policy rate to approximately 3.5% by the end of the calendar year.

Further declines are expected in 2025, with the rate forecasted to reach approximately 3.0% by April. This reflects a gradual reduction of 80 basis points over the period, aligning with expectations of a potential economic slowdown and easing inflation pressures. This shift in monetary policy suggests a more accommodative stance to support growth and stabilize inflation.

REIT index rebounding

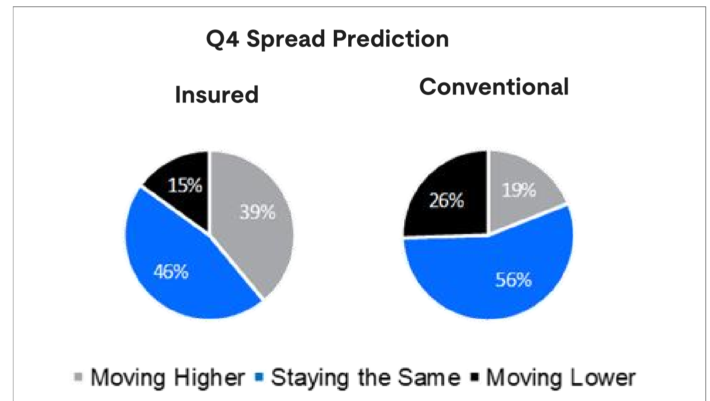
Due to their liquidity, REITs can serve as a leading indicator of whether public markets are bullish or bearish on real estate. Following recent rate cuts and signals from BoC, Canadian REITs have bottomed out and are trending upwards. This shift suggests that the market sees real estate as a favored asset class again after a long stretch of competition with government and corporate bonds.



(Bloomberg, 2024)

Lender sentiments

Recent data from Intellifi's Q3 Lender Sentiment Survey indicates a shift among insured lenders, with a growing number expecting mortgage spreads to rise in the coming quarter. The share of lenders forecasting insured spread increases climbed from 18% to 38%, while those expecting a decrease in spreads for these products dropped by 3% to 15%. In the insured space this is in part due to a lack of allocation available in the 5-year space that is driving up pricing for the available capital. Conversely, the top-tier and conventional mortgage markets appear to be stabilizing, as more than half of lenders anticipate that spreads will remain steady in the coming quarter.



(Intellifi, 2024)

About CMLS

With a strong foundation built over 50 years, we're committed to delivering innovative mortgage solutions that put people first. As a leading Canadian mortgage services company, we provide a full range of commercial, residential, and institutional lending services, delivering the best to all our clients.

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