Grant Thornton

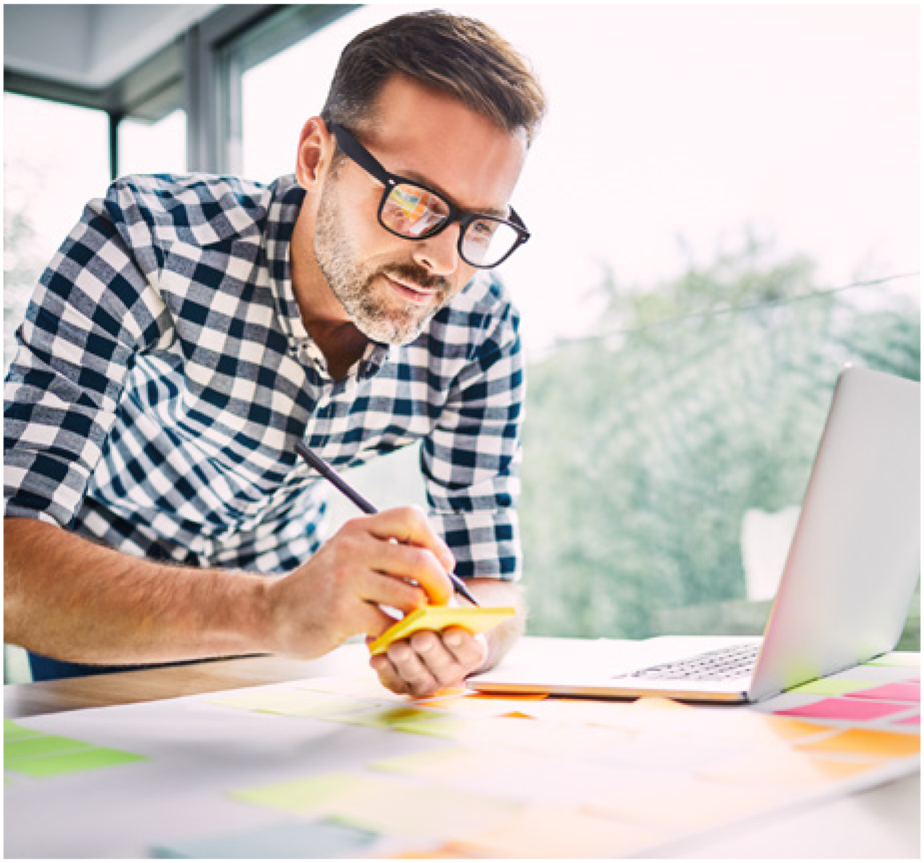
COVID-19: Real estate trend accelerator

When COVID-19 forced Canada into lockdown in March 2020, the real estate industry immediately had to adapt to a new normal. Not only did real estate developers and property managers rapidly implement new processes to facilitate team productivity and safety in the wake of unprecedented stay-at-home orders, but they also had to find ways to protect their tenants and portfolios.

It was a tall order—but the industry was up to the task. Many real estate organizations outlined their response and strategic outlook at the Canadian Real Estate Forum, held virtually from December 2 to 3, 2020. Throughout the forum, attendees heard first-hand how different members of the real estate industry responded in the face of uncertainty and how this unprecedented global event accelerated many real estate industry trends that were already emerging in the marketplace.

Industry players are using COVID-19 as an opportunity to set their businesses up for the future and respond more swiftly to change moving forward. Specifically, the real estate industry has witnessed:

- an adaptation to a remote work environment
- an establishment of stronger relationships with tenants and lenders
- the creation of internal crisis teams, and
- the conduct of more frequent sensitivity analyses.



How will this shift in mindset impact the real estate industry in 2021 and beyond? Here, we explore some of the topics addressed at the industry forum—and how many leading pundits, experts and industry players believe COVID-19 could potentially influence industry trends and actions in the years to come.

What will 2021 bring?

With vaccines being deployed throughout the country, including the possibility of some vaccines developed in Canada, many are hopeful that the end of the pandemic is in sight.

According to Benjamin Tal, Deputy Chief Economist at CIBC World Markets Inc., the impact of the pandemic is expected to be deep but narrow. The first half of 2021 will likely bring a soft market, while the second will see a resurgence in labour income and, with it, an economic recovery. This expectation is further supported by recent International Monetary Fund (IMF) predictions of a 5.5 percent global growth outlook for 2021.

International Monetary Fund predictions of a

5.5%

global growth outlook for 2021

The new Biden administration in the United States will also likely bring good news—not only because of its focus on curbing the spread of the pandemic south of the border, but because the new administration is looking to inject up to 1.9 trillion dollars into the US economy.

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Potential headwinds are forecasted as many industry experts expect various tax increases could be on the table at some point in the not-too-distant future. Additionally, despite the widely pronounced expectation of low interest rates for a long period, many question when these historically low long-term interest rates will rise down the road.

Given these uncertainties, many industry players are torn between preserving liquidity and seizing new opportunities for growth. At this point, it's clear that COVID-19 will have a long-term impact on how people live and work—but the extent of this impact is still uncertain. Similarly, consumer behaviour has been impacted across every industry and asset class, which will inevitably affect everything from buying habits to investor preferences.

For real estate players that have to make business decisions three or four years before shovels hit the ground, navigating this type of uncertainty is particularly difficult. Still, many are strategically developing alternatives to cope with what the future will bring.

2020 real estate: A year like no other

While much remains unknown about the post-COVID era, we can get a hint of what's to come by looking back at the trends that emerged from 2020 in the residential, office, retail and industrial real estate sectors.

Residential: A quest for more space

Unlike most economic recessions, the COVID-19 slowdown was unique in that it didn't seem to dampen housing activity. Not only did housing prices continue to rise despite the pandemic but, thanks to the need for more indoor space spurred by stay-at-home orders and work-from-home arrangements, we saw a renewed interest in more spacious detached dwellings.[1] To satisfy this need, many homebuyers opted to leave urban centres in favour of the suburbs—a trend that may continue as people learn to live without city nightlife and rediscover green spaces.[2]

That's not to say the interest in condo living vanished. In Toronto, sales prices and velocity remained strong; in fact, the city saw 27 new condo projects launch in Q3 of 2020,[3] which wasn't far off from the 31 in Q4 of 2019.[4] And while Toronto 416 condo prices were down 8 percent year-over-year as of January 2021—primarily due to reduced prices in the luxury condo market sector—overall the condo market appears to be on the upswing since vaccine availability was announced in December 2020. As evidence of this, condo unit sales for January 2021 in Toronto were up 85 percent over January 2020 sales.[5]

27 **new condo projects** launch in Q3 of 2020

While the suburbs experienced an influx of detached home buyers, they also saw a record-breaking number of condo buyers. That said, before the pandemic, anecdotal reports indicate that developers were getting deposits of 20 percent before occupancy, a percentage that has since dropped. This has created a hole in the capital stack that developers may have to fill with equity moving forward.

There was surprisingly good news in the residential rental sector as well. Multi-residential vacancy rates[6] and delinquency rates[7] both remained low throughout 2020. At the same time, there was slightly lower rental demand in 2020—a trend that can be attributed, in part, to a decrease in immigration and less demand for student housing. Many short-term rentals, like Airbnb, also transitioned into the long-term rental market, which put downward pressure on rental rates.[8] These trends are likely temporary, however, and won't have long-term effects on city rental markets.[9]

Office: Navigating the future of work-from-home

The office sector has been severely impacted by stay-at-home measures. As companies shifted to remote work set-ups, many were left paying rent for empty offices—a trend that ultimately led to a rise in tenant subletting.[10]

This has led to a dramatic drop in new office construction compared to 2019, and the deals that are going through are more likely to be private capital deals as opposed to institutional.[11] Still, the consensus at the Canadian Real Estate Forum seemed to be that the office real estate market won't be disappearing any time soon. In a post-COVID world, when it's once again safe to work together in an office setting, most experts agree that companies will return to office space.[12]

Additionally, the types of offices these companies choose to rent will likely differ. For instance, many believe the trend toward remote work will continue, as workplaces try to offer their employees more customized and flexible working arrangements. This, in turn, may lead to less people in an office in any given time. Similarly, because the end of the pandemic will likely be a gradual process, companies may need less-dense office arrangements to accommodate social distancing measures,[13] as well as more pandemic-friendly features such as touchless or "smart" washrooms, faster elevators with lower capacities and more green spaces.

Retail: Finding solutions

COVID-19 also hit the Canadian retail sector hard in 2020. From mom-and-pop shops to mall tenants, virtually everyone in this sector suffered from stay-at-home orders and social distancing requirements—with the exception of essential retailers like grocery stores.

While many brick-and-mortar retailers swiftly pivoted to e-commerce in the early days of the pandemic, with even small businesses offering curbside pickup and delivery, many tenants still struggled to keep their heads above water.[14]

The subsector facing the greatest real estate challenges in 2020 was unquestionably enclosed malls. While even small businesses seemed to benefit from a newfound "shop local" mentality adopted by consumers, communities didn't have the same enthusiasm for curbside pickup at shopping malls. As a result, delinquency rates increased in 2020,[15] forcing many landlords to transition from a fixed rent model to a percentage model based on the tenant's sales.

Looking forward, in-person retail sales will likely remain slow for the long term—with the exception of luxury retailers, which could benefit from a surge in pent-up demand.[16] Yet there is a belief that shopping is a cultural experience and isn't about to disappear anytime soon. Investors seem to mirror this opinion, as there still seems to be some interest in this asset class and there have been no signs of panic selling. Additionally, financing remains available from lenders for this asset class.[17]

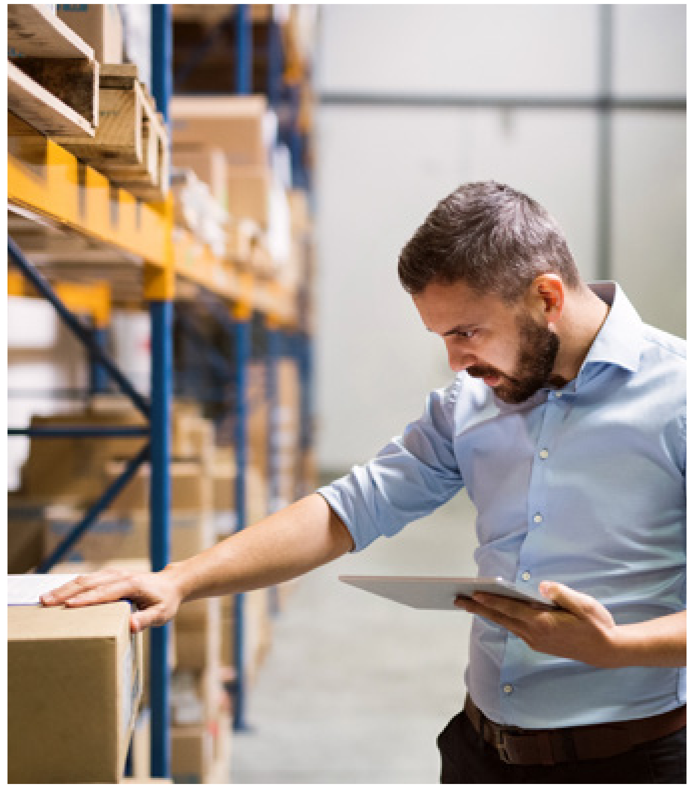
Things are bound to look different towards the end of 2021 and beyond, however. Landlords would be well-served to take time to understand the needs of their customers and potential tenants. Smaller stores and their landlords will likely benefit from a percentage rent model. Historically, landlords have anticipated a predictable income over time without the assumed risk related to the performance of the tenant. However, with percentage rent, the landlord participates in any upside and could earn higher returns, albeit with an increased level of risk. Both the tenant and landlord under this type of lease arrangement work as partners in maximizing revenues from the leased space, while sharing in the risks and rewards. Having a partnership during these challenging times, with new trends emerging faster than ever before, will be a critical success factor in 2021 and beyond.

In a similar vein, landlords may want to revisit their existing structure and consider finding essential services, like grocery retailers or healthcare providers, to anchor their buildings. When planning future renovations, they may also find that large buildings are no longer necessary after COVID-19, and malls with less square footage and more street access are better suited to the new shopping environment.

Government-backed rent subsidies will also directly impact the marketplace in the short term. Both the retail and restaurant industry will benefit from these subsidies, as will landlords. The Canadian government hopes these measures will be sufficient to offset closures and reduced capacity until the spread of COVID-19 is controlled.

Industrial: An essential service

Most—if not all—essential businesses relied on the industrial sector throughout the pandemic, making the industry "essential" in its own right. With warehouse space in high demand and relatively low supply, with very low delinquency rates, the industrial real estate market was somewhat immune to the negative effects of the pandemic.[18]



That's not to say COVID-19 didn't make an impact. The surging demand for e-commerce and last-mile logistics is expected to drive up rent and real estate prices in this space. And a trend toward more modern features—such as larger distribution centres, deeper bays for storage and loading, and automation to enhance sorting and delivery[19] —is forcing landlords and developers to embrace change in new ways. This, in turn, is posing a challenge of its own as industry players attempt to navigate slower-than-usual construction timelines.

Demand for industrial real estate is shifting geographically as well, with Calgary becoming a popular West-coast hub for many companies. As a result, demand for distribution warehousing in this area is on the rise—which is leading to increases in rental rates. Simultaneously, the use of industrial space in certain cities such as Montreal is rising as well.[20]

Overall, it will be difficult to predict how dramatic recent trends like e-commerce will impact the industrial real estate sector over the long term. That said, it's quite likely that rental rates will remain high and vacancy low—and, as a result, industrial real estate will stay strong and in-demand.

Looking forward to 2021 and beyond: The trends that will shape us

To move past the effects of 2020, it is important for the real estate industry to look toward the future and identify opportunities to bounce back stronger. Below are just a few trends that many real estate industry experts believe will evolve to define our new normal in 2021 and beyond.

A new approach to work

The rapid shift to remote work forced organizations to alter their physiologies in unprecedented ways—revisiting their approaches to things like productivity, work/life balance, mental well-being and collaboration. But while the experiment worked, to a degree, industry thought leaders believe companies likely won't maintain complete virtual arrangements moving forward. They are simply too isolating, too difficult on working families and they encroach upon the important division of work and home.

Instead, it's much more likely that a vast percentage of businesses will adopt hybrid models—arrangements that give people control of where they work best. Through this model, organizations will be able to ensure their workers are productive and happy, while simultaneously allowing for in-person collaboration, the building of stronger corporate cultures and diversity of thought. Many may also go one step further by prioritizing healthy workplace cultures designed to alleviate stress—which, in addition to new workplace policies, will also involve real estate that offers room for gyms, in-office yoga sessions and other health-focused activities.

A fresh perspective on how cities function

With an increasing number of city dwellers migrating to the suburbs in favour of larger homes, and those remaining being forced to work from home, the state of many downtown cores deteriorated dramatically in recent months. Without the lure of restaurants, night life and other recreational activities, it's possible COVID-19 could launch many downtown centres into a downward spiral, and see real estate prices drop, and businesses fold, as a result.

To avoid this outcome, the real estate industry will have to re-evaluate its role in contributing to thriving urban centres, and work alongside city planners and government officials to meet the evolving needs of city dwellers. For instance, enticing new suburban homeowners to venture back into the city may require a modernized public transit system. Cities also need to look beyond offering the basics, such as good food and cleanliness, and discover new ways to help people connect with each other through shared public spaces.[21]

To accommodate post-COVID work trends, developers may consider building multi-purpose buildings that create integrated experiences—offering residential, office, daycare and gym spaces in one concentrated area. Governments may also need to be pushed to reduce taxes on downtown properties as property values shift.

Given that COVID-19 shed a harsh light on the economic disparity in many of our cities,[22] new developments need to be planned with marginalized communities in mind—focusing on things like affordable housing, easy access to transportation, healthy food options as well as shared public spaces.

A push toward impact investing

The growing popularity of impact investment funds is changing the face of real estate. Today, many fund managers are not only looking for profitable endeavours but also for those that meet specific environmental, social and governance (ESG) benchmarks.[23]

To mitigate risk, fund managers are scrutinizing potential real estate deals like never before and asking a lot more questions upfront. An attractive investment is one that not only pays lip service to ESG, but that embeds ESG principles into company culture. In response, many builders and landlords are shifting their organizational cultures and mandates to put tenants, communities and the environment first—either by using more green materials, leveraging advanced technology to monitor things like air quality, installing solar panels and other forms of renewable energy to lower their carbon footprint, or uncovering new ways to fill local housing needs.

Moving forward, we may see a shift from traditional condo developments built with foreign investors in mind, and more innovative designs and dwellings that appeal to both high- and low-income families, reduce urban sprawl and offer more shared green spaces—all while reducing environmental impact. Real estate companies may also start paying closer attention to the "S" in ESG and strive to build businesses that put diversity first.

The future is PropTech

PropTech, or property technology, is another area attracting attention from residential and commercial property owners alike. By offering one integrated IT system, property owners, managers and landlords can not only better manage their assets but also collect invaluable data. They can also connect a tenant-facing app to this system so that tenants can seamlessly and efficiently fulfill day-to-day tasks like making rent or lease payments, logging guests in or submitting work orders, or gathering critical property data that provides information that the tenant wants to see.[24]

This type of technology is already being used to help enhance occupant safety through sensors, cameras and app-controlled locks; air quality and energy conservation efforts through AI-powered intelligence centres; and occupancy rates through virtual tours. Commercial real estate managers are also leveraging this technology to help shoppers plan their mall trips before getting to the property—and cost-effectively upgrade some of their 50-year-old buildings.[25]

Given the growing popularity in this type of technology, we've already seen many partnerships and acquisitions of PropTech companies, and that trend is expected to continue throughout 2021 and beyond.

E-commerce advancements, ahead of schedule

Companies across all industries made significant investments in e-commerce at the beginning of the pandemic, placing them four or five years ahead of their pre-COVID adoption rates. They are expected to build on that investment moving forward.

Experiential retail, which offers an element of entertainment to the retail experience, will continue to expand online, as more companies offer livestream sales events,[26] video conferencing shopping appointments[27] and other exciting experiences designed to remain top-of-mind with customers and, one day, drive customers to their stores.

This digital transition will also likely lead to a more integrated business experience, with many retailers embracing machine learning-powered demand forecasting and other analytics measures to improve business performance.

A fresh beginning

While 2020 wasn't the year anyone was expecting, COVID-19 did offer a few silver linings. Not only did it allow us to slow down, take a step back and focus on what's important, also it opened our eyes to new opportunities and forced many companies to accelerate many business goals that would have otherwise sat on the back burner.

Throughout 2021, countless businesses and individuals—in the real estate sector and beyond—will build on the lessons of adaptability, communication, diversity and collaboration that they learned through the COVID-19 pandemic and embrace innovation. Tenants, customers, property owners, developers, property managers and investors will find new ways to rebuild after COVID-19 to ensure the greatest level of success for everyone.

And that rebuild will likely happen soon, as we approach the tail end of what many believe will be a W-shaped recovery. From a drop in market values in some real estate segments in March 2020, to a rapid recovery in the summer brought on by re-opening of the service industry (albeit for a very short time), to a second drop as we entered the second wave, many economists now believe that barring an impactful third wave of COVID-19, there is optimism for a speedy economic recovery and the real estate industry must be ready.

Whether you're looking to seize new opportunities in the post-COVID era—or get ahead of future trends now—Grant Thornton can help. From analysis of optimum performance of existing real estate assets to PropTech integration to business and consulting advice, our experienced advisors will work with you to plot the best path forward.

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