Lethbridge office market report

Q2 2024

Lethbridge market indicators

1.367M **square feet (sf) estimated total inventory**	▼ **10.07%** **office vacancy rate** down from 11% in Q2 2023	▼ **9.52%** **average building vacancy** down from 12% in Q2 2023
▼ **29,436 sf** **new construction** down from 36,676 sf in Q2 2023	▲ **$18.59** **average base rent rate per square foot (psf)/year** up from $15.82 in Q2 2023	▲ **$9.34** **average additional rent rate psf/year** up from $8.67 in Q2 2023

Lethbridge office market breakdown

985,316

estimated downtown inventory
sf of office real estate

▼11.33%

downtown vacancy
downtown available office space
down from 14.8% in Q2 2023

$24.34

average downtown gross rent
leases transacted last two years psf,
including additional rent

381,797

estimated suburban inventory
sf of office real estate

▼5.82%

suburban vacancy
suburban available office space
down from 7.25% in Q2 2023

$31.75

average suburban gross rent
leases transacted last two years psf,
including additional rent

Lethbridge office market trends

01.

Flight to ‘new’

The expression ‘flight to quality’ describes the shift in demand from office users for high quality space with more amenities, despite the higher psf lease rates. We are now seeing an extension of that trend where, instead of exclusively class A and class AA space, office tenants are moving from aged inventory into newer office space. The vacancy rate of office buildings completed since 2015 is estimated below 1% of the national office vacancy rate of approximately 14.3%.

Similarly, in Lethbridge, the majority of vacant space is older and may require significant renovations to attract new tenants. The suburban vacancy rate in Lethbridge is less than half of the downtown vacancy rate, which could be in part due to suburban office typically being newer.

02.

Inventory vs. vacancy

Office vacancy in Lethbridge has decreased by nearly 1% since 2023, with positive overall absorption. New office construction has predominantly been owner-users, however recently there are new developments in the community building office space on spec, expecting to secure tenants upon completion by the end of 2024.

Nationally, 2022-2023 saw the delivery of over 16 msf of office space to the market. However, active construction in office real estate has fallen below 9.1 msf, the lowest level since 2011. In Q1 2024, 1.7 msf of new office supply was completed, with no new projects breaking ground in Q2 2024. This construction slowdown in major markets will likely continue until vacancy rates return to levels that support new development.

03.

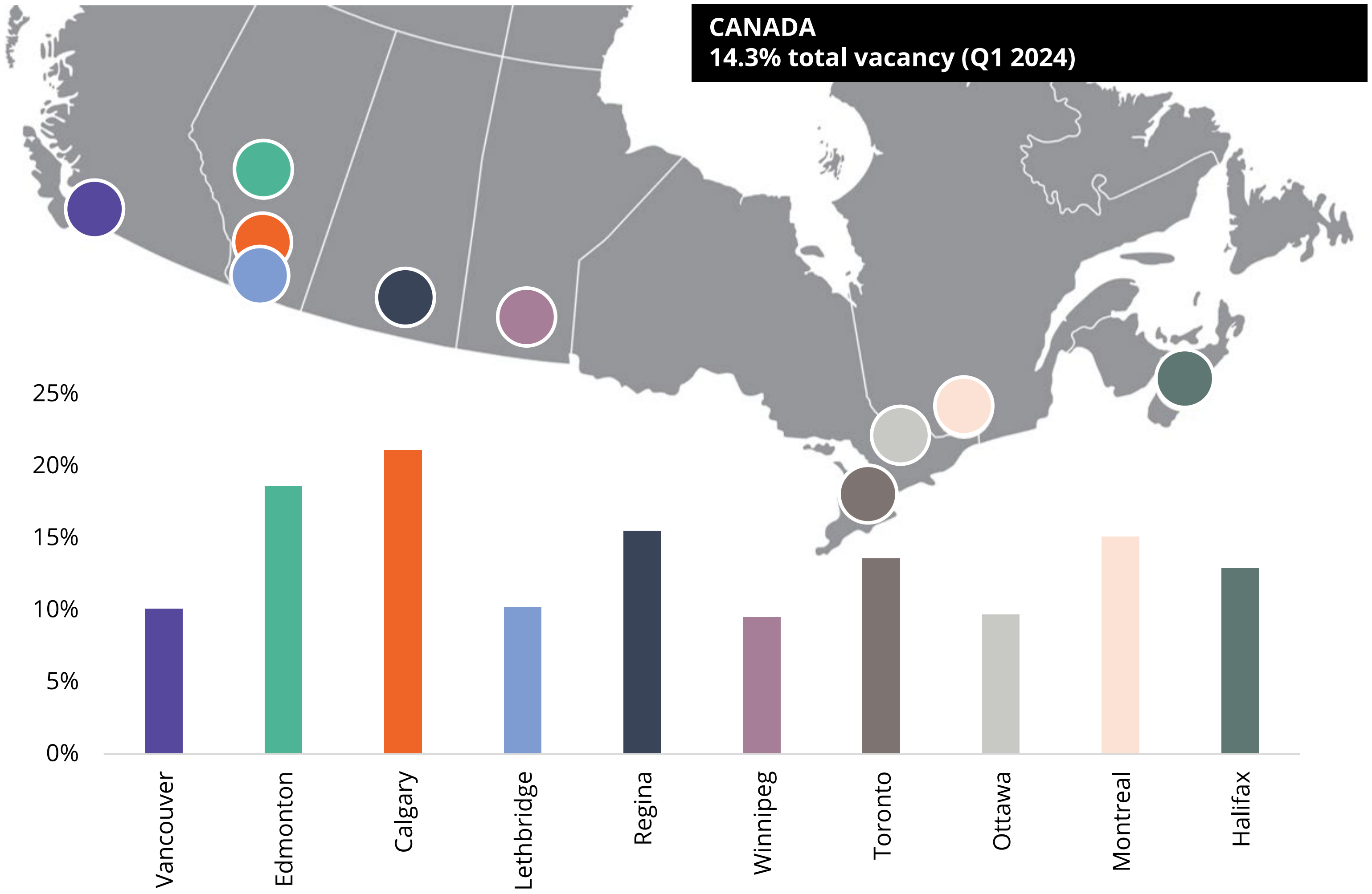
Economic trends

The Bank of Canada (BOC) reduced the overnight interest rate to 4.75% on June 5, 2024, after having opted to hold the rate at 5% for six quarters following 10 consecutive rate hikes. With inflation stabilizing below 3% in 2024 and the cooling of the national GDP, the BOC rate announcement was expected. However, despite the economy slowing, job growth remains steady. The BOC had predicted and encouraged the employment rate to drop as a control on inflationary pressures. Although inflation has normalized at an ‘acceptable’ level, employment remains steady at 61.3% as of May 2024.

Despite the drop, the appetite for office real estate may require further market incentives to stimulate transactions. Investor sentiment is still extremely cautious with high vacancy and cap rates.

National office vacancy

Major Canadian cities office vacancy rates



Source: AVANT by Avison Young

Office vacancy

Nationally, office vacancy continues to moderately decline in nearly all major markets. Generally, office footprints have been shrinking and sublease space is at an all-time high in the major markets. The shift in office mentality following the pandemic has translated into a continued decline in the size of office footprints as businesses shed underutilized sf for the sake of profitability. Additionally, although Canada is experiencing the same market conditions as the United States, it's important to remember that the "shock-value" rhetoric regarding the U.S. office market is describing an entirely different market. While Canada has approximately 500 msf of office inventory, the significantly more populous U.S. is experiencing the highest vacancy in its history at an estimated 1 billion sf of vacancy; double the *total* office inventory of Canada.

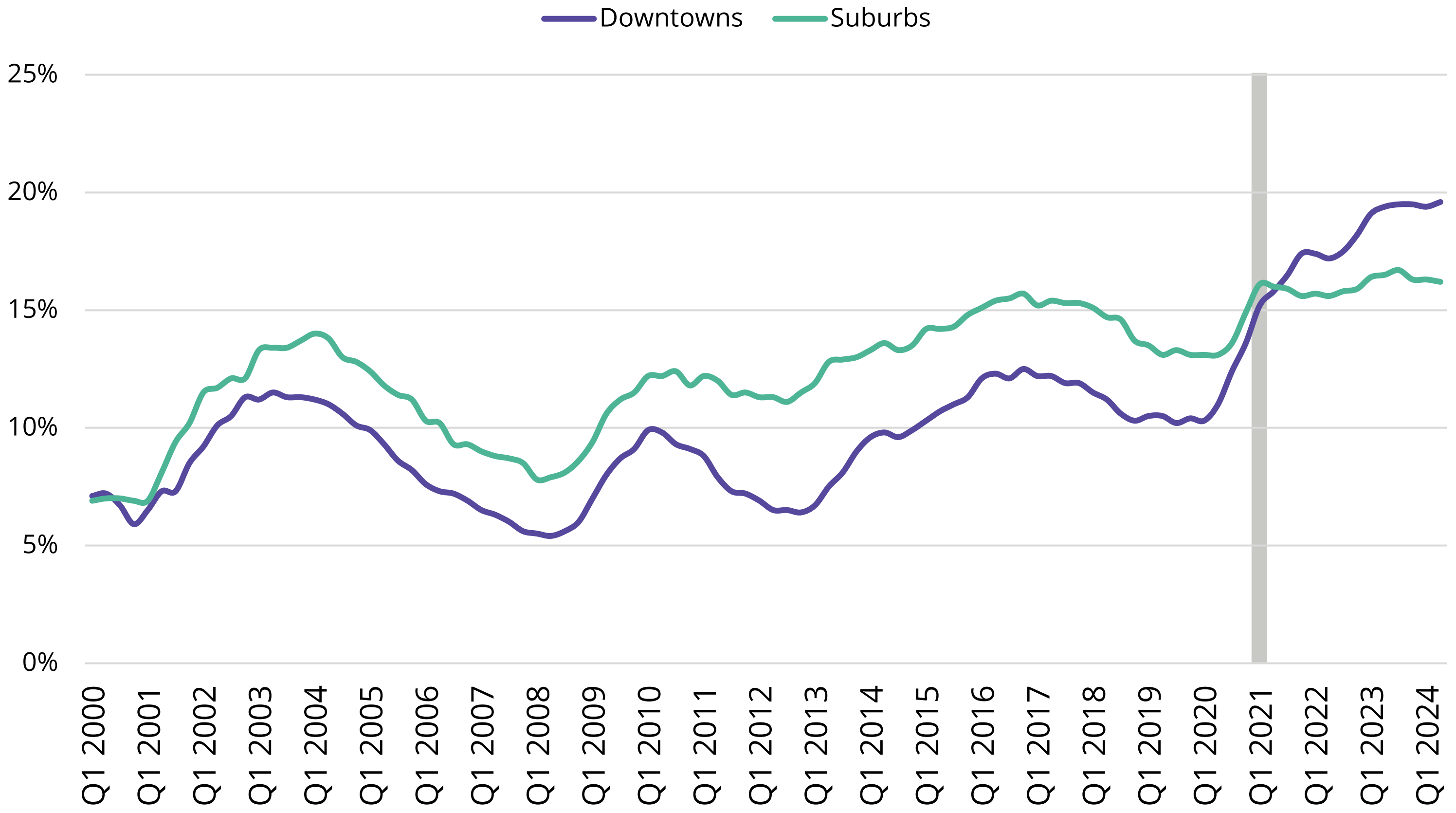
The Lethbridge office market has an inventory of approximately 1.3 msf, with 134,000 vacant sf. Of that, over half the vacancy can be attributed to downtown office towers. This is a number that makes sense for our market and local market sentiment.

"Since market sentiment plays such a significant role in office real estate transaction volumes and outlook, it's important to remember that Canada is not on the same scale as the U.S., and Lethbridge is not on the same scale as primary markets such as Calgary. We need to pay attention to CRE rhetoric and really figure out what applies to tertiary markets like Lethbridge."

– Ashley Soames, Senior Associate

Downtown and suburban bifurcation

Total availability rate in downtown vs. suburbs



Source: AVANT by Avison Young

Availabilities in downtown vs. suburbs

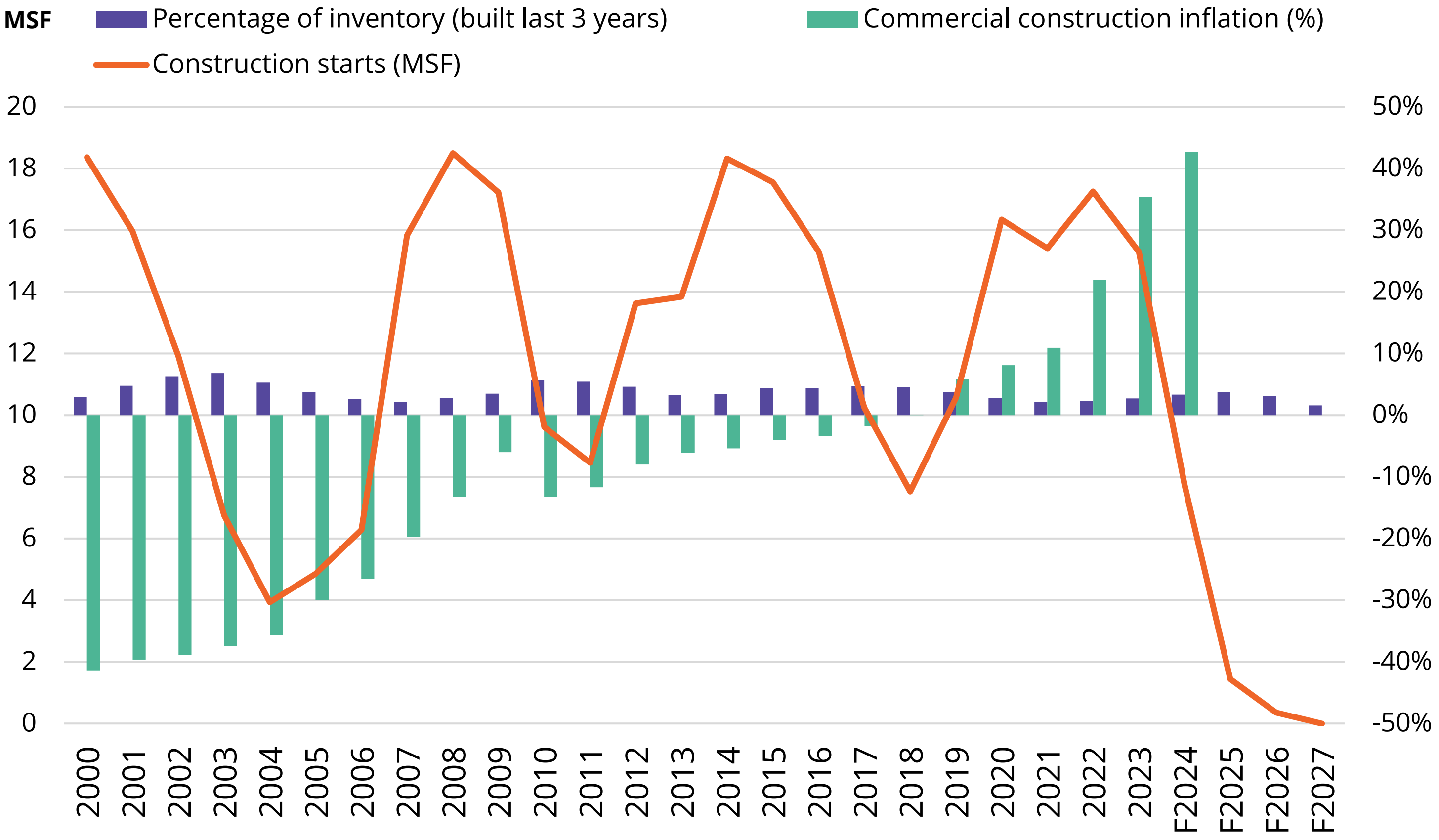
VANCOUVER 12.5% Downtown 6.5% Suburban	**TORONTO** 14.4% Downtown 12.8% Suburban
EDMONTON 18.6% Downtown 10.7% Suburban	**OTTAWA** 10.0% Downtown 10.9% Suburban
CALGARY 26.9% Downtown 16.1% Suburban	**MONTREAL** 15.5% Downtown 13.4% Suburban

LETHBRIDGE
12.2% Downtown
05.8% Suburban

Historically, suburban office space had higher national vacancy than downtown office space until 2021 when the effects of the COVID-19 pandemic inverted this relationship. This shift represents a significant change in market sentiment and the priorities of office users. Although downtown spaces are often attractive and close to amenities, suburban spaces are typically newer and may be more accessible to office workers who live in the surrounding suburbs. This division, or bifurcation, is consistent across nearly all markets. In Lethbridge, suburban office space represents just over a quarter of the total inventory and has half the vacancy rate of the downtown.

Office construction and share of new inventory

Major market indicators



Source: AVANT by Avison Young, Statistics Canada

Construction costs and demand

The COVID-19 pandemic occurred during a growth period in the construction cycle of typically five to six years; as such, 2023 saw a high number of new office deliveries. Since then, there has been a slowdown in office construction to historic lows due to the high vacancy and low transaction volumes. Although vacancy is tight in new and class A spaces, it is unlikely that we will see a return to pre-pandemic construction levels in the near future.

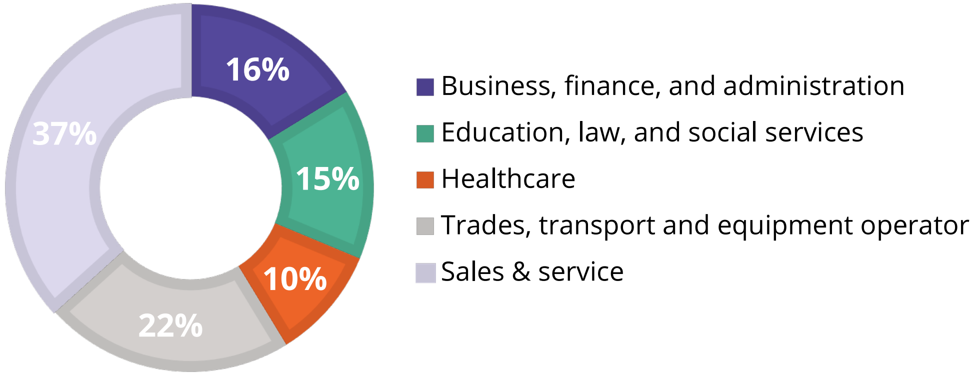
The Lethbridge market is divided between old and new office space, with average lease rates of $5+ psf more in suburban office space than the downtown. Office tenants are seemingly prepared to pay higher lease rates for new, quality space. With construction inflation easing on trend with overall CPI, we have seen some new office development. Much of it is nontraditional in the sense that the spaces are flexible and have the potential to appeal to a variety of users. Although the new construction is a small percentage of the overall inventory, it shows a return to normal growth in the local office sector.

“A big question right now for most markets is ‘how high do rents need to be to cover the cost of new construction?’ With construction inflation still significantly affecting development overhead, the expectations for market rents have been adjusted accordingly and tenants looking for newly built office space seem to understand that.”

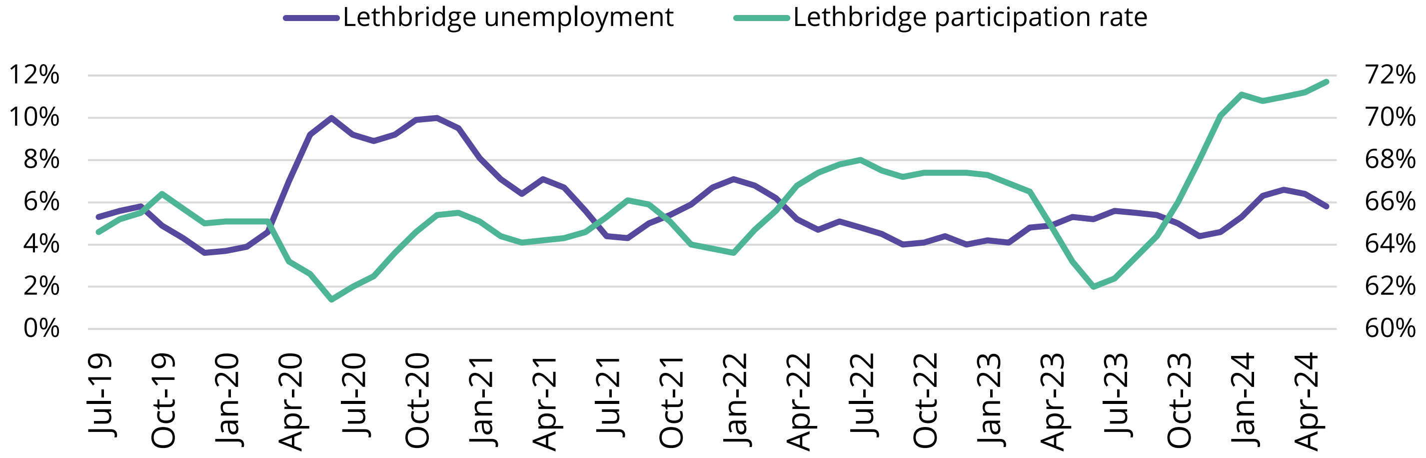
– Jeremy Roden, Executive Vice President

Lethbridge labour market

Top occupations in demand in Lethbridge, June 2024



Lethbridge unemployment and participation rate



Employment and inflation

The COVID-19 pandemic created an unprecedented disruption in the labour market, causing a 16.3% loss in job availability at its peak. However, due to a consistently strong economy, the job market was considered fully recovered within 20 months of the decline. The BOC has indicated that a strong job market is a root cause of inflation, bringing a wage-price spiral. However, as employment and participation rates have normalized and even shown recent downturn, employment does not seem to directly affect inflation as it did during historical economic slowdowns. Similarly, net absorption of office space is actually negative, considering the increase in labour opportunities in office user sectors. The number of job postings is above pre-pandemic levels, which suggests CPI inflation was not driven by wage inflation. Remote work and hybrid work are no longer assumed to be the main cause of shrinking office footprints. Instead, it is most likely that office users are adapting to a changeable business outlook and downsizing office space to better control their costs. Calgary has reported a 90% return-to-office at a minimum of three days per week, and in Lethbridge we assume the return rate to be even higher.

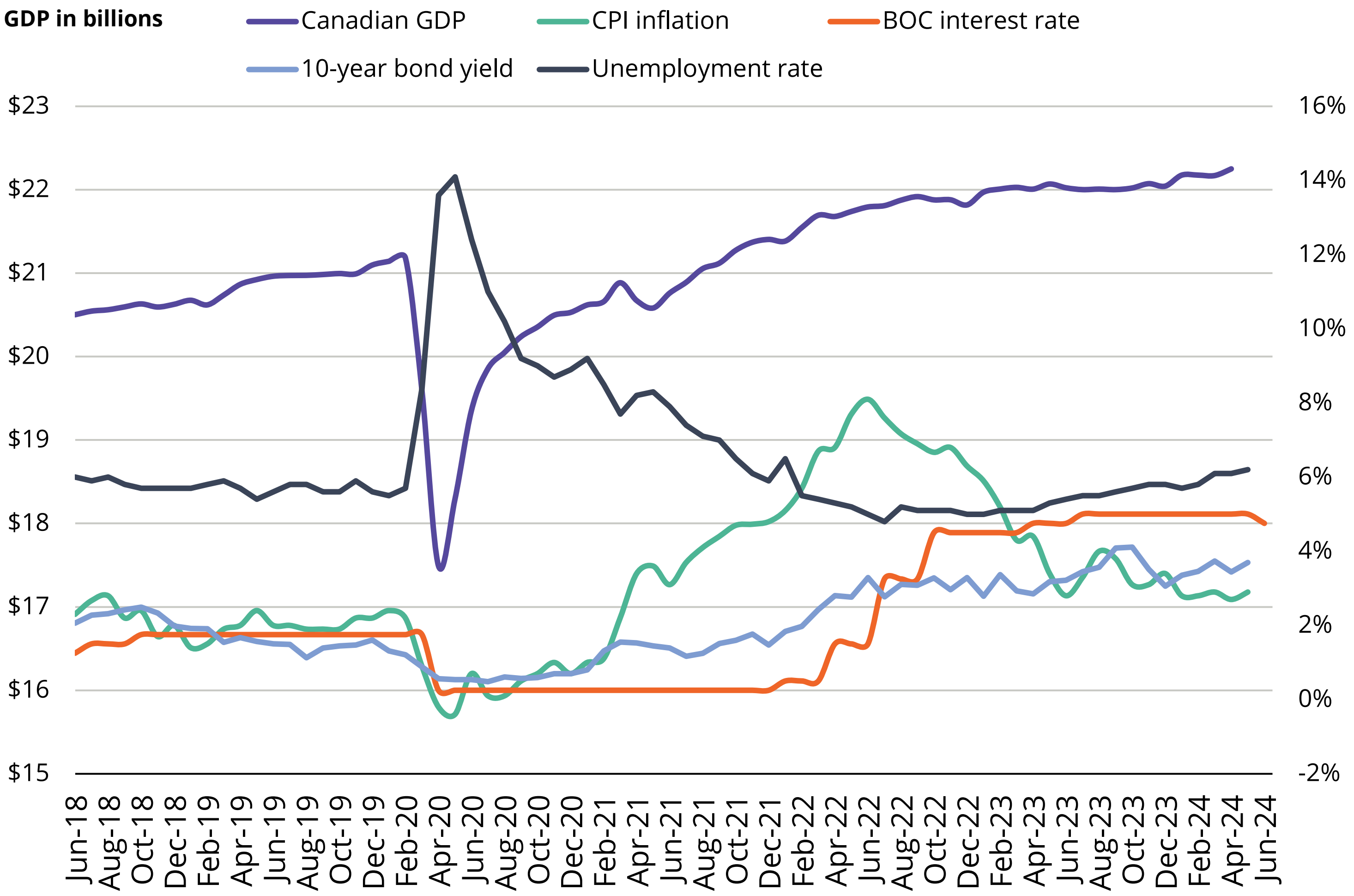
"Much of the conversation around remote work applies to large cities where commute times are a significant deterrent to returning to the office full-time. Because Lethbridge is a '15-minute city,' a reduction in office footprints would not likely be a result of hybrid working arrangements."

– Ashley Soames, Senior Associate

Source: Lethbridge Economic Development, Statistics Canada

Market conditions

Major market indicators



Source: Statistics Canada, Bank of Canada

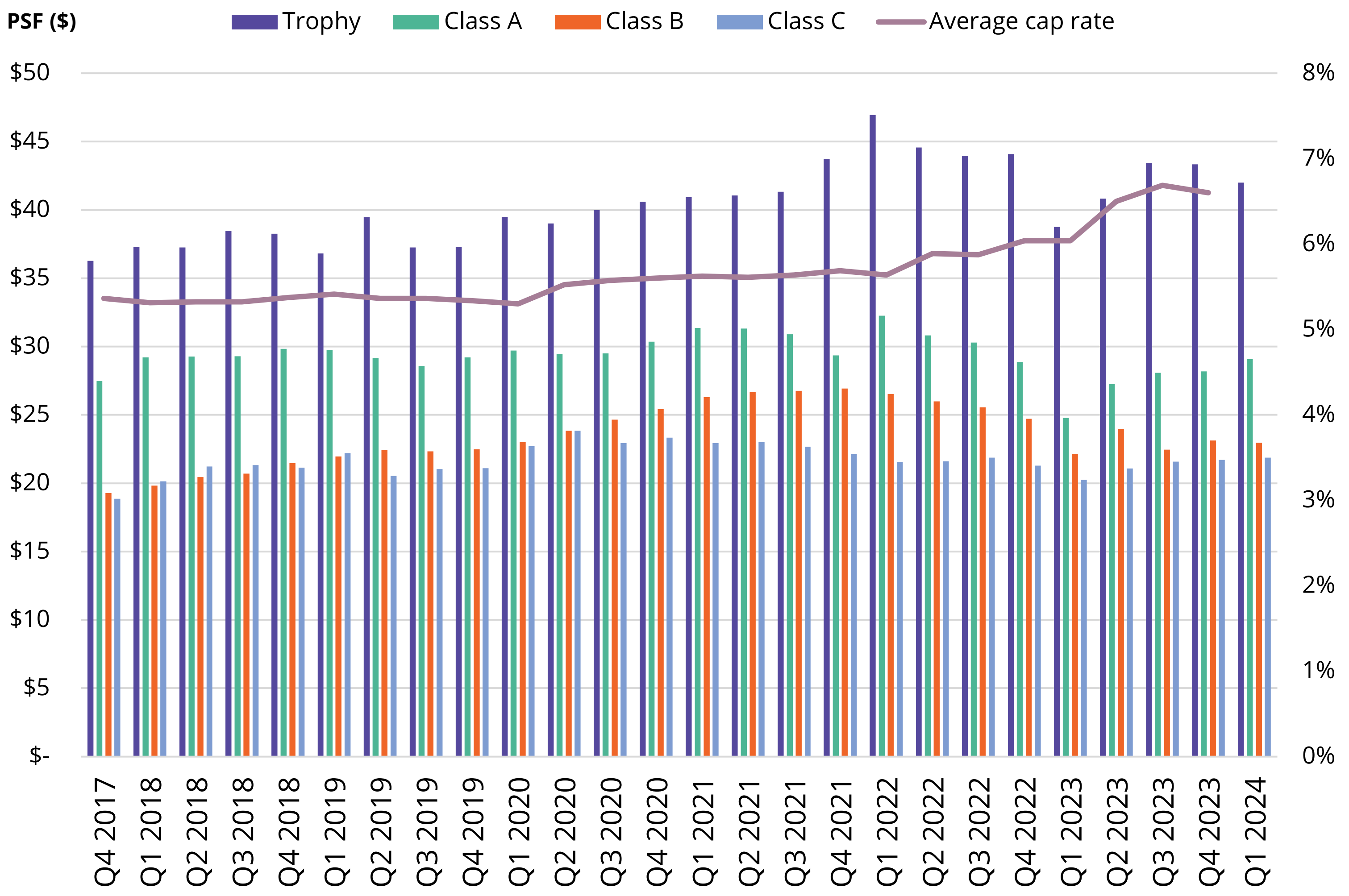
Inflation and interest rates

Bolstered by CPI inflation trending below 3% since January, the Bank of Canada (BOC) announced the first overnight interest rate drop since 2021, from 5% to 4.75%. Although inflation upticked 2.9% in May, there is still optimism that the BOC will continue to gradually reduce interest rates this year. Additionally, GDP growth has slowed since Q4 2023, and domestic demand has been contracting despite a strong labour market. Based on Statistics Canada's predictions, GDP would need to grow at an average of 1.7% per capita, per year to return to its pre-pandemic trend by 2034. With the 25-point interest rate drop and 'pent up demand' in the market, we may see a small uptick in CRE transactions in Q3, but it will likely have a delayed effect on the market. Much like how the interest rate hikes of 2022 affected the slowdown of the market in 2023, if the BOC continues to lower the rate, transaction volumes may regain some momentum by the end of 2024. National office CRE sale volumes were reported at a seven-year low of $282.8 million as of Q1, according to a May 2024 report from Morguard Corp.

In Lethbridge, CRE transactions have remained steady among owner-users and investors. Although numbers are low comparatively to retail or industrial asset classes, they are normal for our market which generally sees few office transactions. Since July 2023, office sales have transacted at an average of $225 psf with an average size of approximately 4,500 sf.

Asking net rents by building class

Downtown office real estate – 6 major markets



Source: AVANT by Avison Young

Office investment trends

Nationally, investor sentiment toward office real estate has been negative due to high vacancy and stagnant asking rents. Because inflation has outpaced office CRE income growth, REITs have been the largest net sellers of office real estate since 2023. However, despite market sentiment driving valuations, office assets still perform well on paper due to a lack of transactions in the market. Currently the spread between capitalization (cap) rates and the 10-year bond yield is approximately 300 basis points, which technically shows office assets to be low-risk compared to historically. However, if the yield spread were reported based on market conditions rather than completed transactions, the spread could be as high as 500 basis points with cap rates of 8%. Similarly, the valuation of an asset should look at several factors, not exclusively cap rates and net operating income (NOI). Other considerations could include financing costs or the cost of borrowing capital, market variability and risk profiles, psf valuation, and the functionality and future desirability of a property. The slowdown in new office builds, for example, is a market variable that could reduce vacancy and increase asking rents.

In Lethbridge, we are seeing new office development from investors as part of flexible mixed-use plazas where multifamily housing, retail, and office are integrated into a full-service community hub. Investors are developing this new office space on spec, without pre-leases in place because of the strength of the local office market and the flexibility of these mixed-use spaces to appeal to a variety of users.

Office towers in Lethbridge

Location	Average year built	Total square feet	Vacant square feet	Average % vacant	% of total Lethbridge vacancy
Downtown	1980	643,310	99,793 (est.)	15.5%	75.5%

Source: Avison Young

Buzzwords in office real estate

‘Artificial Intelligence’

Artificial intelligence (AI) became publicly available in 2024, causing a huge technological shift for many businesses. Office workers, often referred to as ‘**knowledge workers**,’ perform a variety of duties that are easily accomplished by AI, particularly data collection, interpretation, and organization.

A U.K. study, published in March 2024, estimated that as many as 8 million jobs (many of which are knowledge jobs) could be made obsolete by AI. Because businesses have refocused on streamlining their space needs, this has future implications for the footprints of office users. It could represent a major shift in the industry in the near future.

‘Place-making’ and office space

Place-making is the idea of creating a holistic experience for the office worker that encourages collaboration through the desire to be present in the office. These new ‘trophy spaces’ are the top class of office space that is bespoke to the user with specific amenities to support their corporate culture. Despite the high asking rents in this class of space, availability in trophy-class office space is only 5.4% as of Q1 2024.

This is partially a cause of the **bifurcation** (another buzzword simply meaning ‘split into two’) between classes and ages of office space, with trophy class space leasing for nearly double the average lease rates of class B and class C space.

Office conversions; adaptive reuse

The **adaptive reuse** of office real estate into multifamily housing has been an exciting proposal to address high vacancy. Although stakeholders support removing vacant office space from the market through residential conversion, it can be as costly as new development, with more uncertainty and difficulty. Additionally, less than 2% of all vacant office space has the potential to be converted to residential.

Despite the varied success and high input costs, the federal government pledged $1.1 billion CAD to convert its underused office buildings into housing as part of the 2024-2025 budget with the goal of creating 250,000 new homes by 2031.

Summary

How do we resolve office vacancy in Lethbridge?

Office tenants in Lethbridge will likely see new space come to market by the end of 2024. Those office tenants who are looking for high-quality office space may opt to move into these new developments at higher lease rates. Tenants who are in relatively new spaces already will likely renew where they are or may opt to purchase and develop their own space as an owner-user. Some large-format tenants may also have the option of negotiating with landlords for custom built-out space in redeveloped office buildings. Canadian Western Bank (CWB) moving into the previous Scotiabank building located at 702 3rd Avenue South is a great example of a national tenant working with a landlord to redevelop existing office space. Landlords may also need to be amenable to the shift in tenant mentality, where shorter lease terms and greater flexibility are important to tenants.

"Vacancy is low in new office spaces with lots of amenities, while spaces that are aging or require redevelopment make up the majority of our local vacancy. Landlords looking to attract modern tenants need to invest in improvements that will increase the asset's appeal and help grow its profitability over time."

– Ashley Soames, Senior Associate

We are also seeing non-traditional tenants backfilling some of the older office space in our market and utilizing part of the built-out space to keep fixturing costs down. With an influx of demand for medical office, wellness, and social services since 2020, office vacancy will likely either see higher absorption or increased new development.

Economic growth will support continued demand for office space in Lethbridge. As a community of over 106,000 residents, Lethbridge has a diversified local economy with a highly educated population and sustained demand for services. With an anticipated slowdown in new builds, the 10.22% vacancy of 126,900 sf (est.) should be able to be absorbed in our market by regular market demand, excluding any obsolete or aged space. Market sentiment towards office CRE is beginning to change at the local level as investors view office space as an important component in new mixed-use developments. We may see this sentiment grow stronger in the near future as the BOC rate drop and moderation of inflation have improved business confidence.

"Economic growth is the most significant precursor for a strong commercial real estate market. Although local governments and stakeholders cannot create economic growth, they can focus on the prerequisite conditions for prosperity, such as education, affordable housing, local investment, tax incentives and grants, and presence building. For property owners, property upkeep and active participation in the community are the best ways to grow the value of a real estate asset."

– Jeremy Roden, Executive Vice President

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