



Lethbridge office market report

July 2023

**AVISON
YOUNG**

Lethbridge office market trends

01

Flight to quality

Absorption in A-class office space remains robust in nearly all markets. The term 'flight to quality' refers to the post-pandemic trend of a return-to-work shift, where office users have demanded higher quality workplaces with modern finishes and more amenities.

Our take on this trend...

In Lethbridge, tenants are focusing more on the quality of the space than the per-square-foot cost. Office offerings in **B- or C-class space have higher vacancies** and will require proactive landlords to reinvest in the property to attract and retain tenants. New office developments are primarily suburban and/or have office users occupying traditional retail spaces in mixed-use plazas.

02

Adaptive reuse

To combat the record high office vacancies in primary markets, the conversion of office space to residential or retail has become a focus. In line with '15-minute cities,' adaptive reuse supports microeconomies where people work, live, and shop in city centres.

Our take on this trend...

Because of its significantly smaller population, **Lethbridge itself is a '15-minute city.'** Adaptive reuse is an exciting directive for primary markets with large-scale projects, however, small communities have long been repurposing existing space to fulfill local demand. Vacant office spaces could be potentially repurposed by non-traditional users without large-scale redevelopment.

03

Inflation and expenses

Market conditions have put additional stress on office investors, owners, and users. With the inflated cost of building materials, increased interest rates, and a tight labour market, the cost of doing business is high and affecting market sentiments.

Our take on this trend...

Lethbridge is somewhat insulated from the larger economic slowdown because the diversified local economy is supported by a strong agribusiness base. However, due to inflation, **the cost of building out office space has effectively doubled since 2019.** This presents a huge obstacle for new office developments and for owner-users and tenants building out their space.

Lethbridge office market fundamentals

Estimated total inventory (M sf)

1.2 M

square feet (sf) of office real estate
as of Q3 2023

Overall vacancy (%)

11%

of available office space
as of Q3 2023

Average building vacancy (%)

12%

as of Q3 2023

Estimated planned construction (sf)

36,676 sf

new office builds planned
as of Q3 2023

Average asking rent (\$)

\$15.82

per sf, per year
as of Q3 2023

Average additional rent (\$)

\$8.67

per sf, per year
as of Q3 2023

Lethbridge office market breakdown



DOWNTOWN

Estimated downtown inventory (sf)

862,000

sf of office real estate as of Q3 2023

Downtown vacancy (%)

14.8%

of downtown available office space as of Q3 2023

▼ from 18.9% in Q3 2022

Average downtown gross rent (\$)

\$22.92

per sf, per year, including additional rent as of Q3 2023

▲ from \$21.81 in Q3 2022



SUBURBAN

Estimated suburban inventory (sf)

343,000

sf of office real estate as of Q3 2023

Suburban vacancy (%)

7.25%

of suburban available office space as of Q3 2023

▼ from 14.5% in Q3 2022

Average suburban gross rent (\$)

\$26.05

per sf, per year, including additional rent as of Q3 2023

▲ from \$25.23 in Q3 2022



“Office users are prioritizing flexible, functional spaces that support their corporate culture and help retain staff, over the per-square-foot cost of the space. Successful landlords are taking this shift in mentality into account and are actively investing in their spaces.”

- Ashley Soames

Senior Associate, Avison Young

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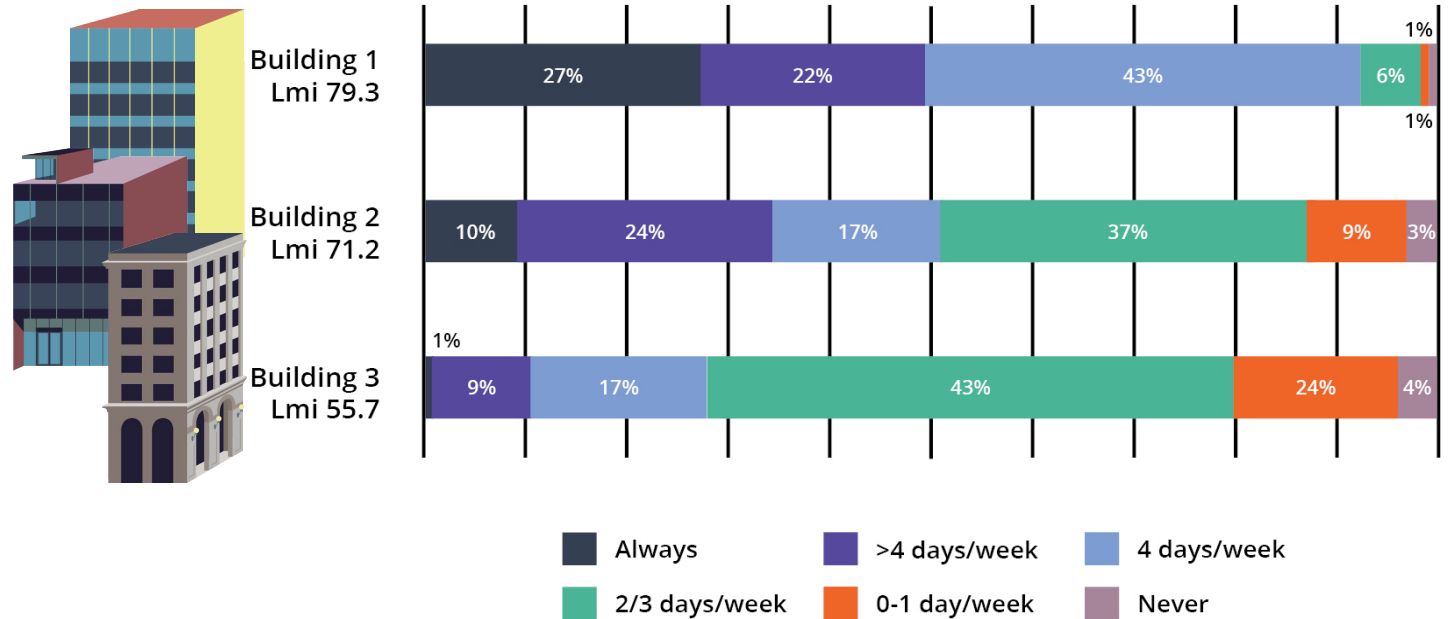
Demand for A-class office space

An employee's market; a tenant's market.

With an extremely low unemployment rate of 5.2% nationally as of May 2023, the labour force has been termed an 'employee's market,' where employees in high-demand knowledge jobs have mobility and negotiating power. This goes hand-in-hand with the office market being termed a 'tenant's market,' where tenants have stronger negotiating power based on the high vacancy. With these two factors, the demand for office space has shifted from rate-driven to quality-driven, where the retention of employees and tenants is the top priority. This trend is reflected in a recent survey conducted for Avison Young on employee satisfaction in three office buildings with different LMI scores.

In mid-size markets where A-class office space is less readily available, tenants can demand higher tenant improvement allowances (TIA) or other inducements for the improvement of the space. In Lethbridge, the inclusion of TIA used to be negotiated on a case-by-case basis, but now it is an expectation. However, this works in the landlord's favor as the inclusion of TIA and other inducements has actually supported lease rates with moderate increases in line with inflation. TIA also gives tenants the flexibility to effectively amortize certain costs rather than absorb them upfront.

When surveyed as to how much time they prefer to spend in the office, employee responses varied drastically between different building classes.



The Leesman LMI score (LMI) is the score a workplace receives based on functionality and effectiveness, including work activities and the impact of the workplace on daily life; this score also includes reporting on infrastructure needs.

The report scales buildings between 1-100. In the above example, Building 1 is exceptionally good, Building 2 is above average, and Building 3 is a 'market normal' building.

Lethbridge adapts

Office vacancy and the potential for new users.

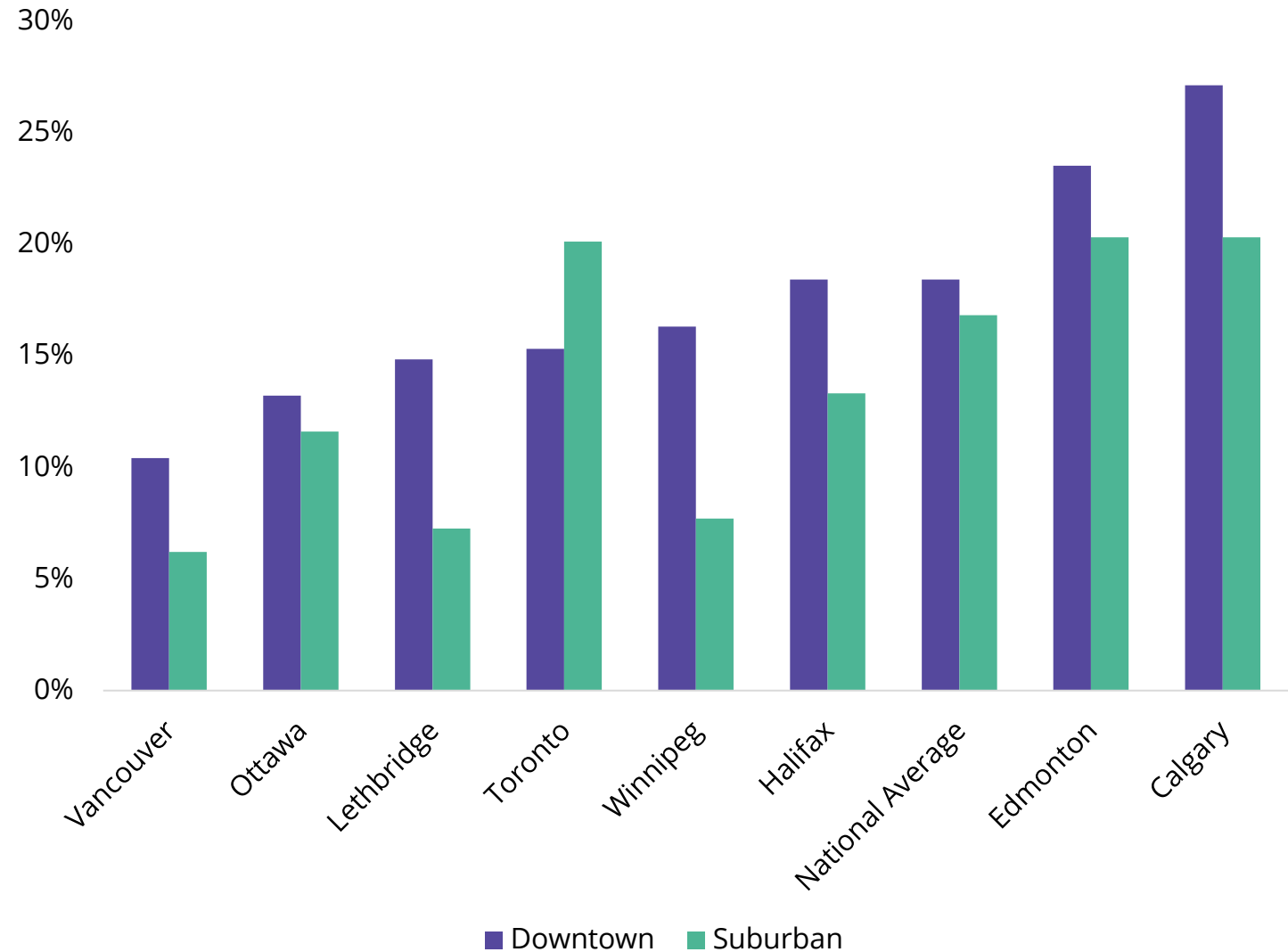
Adaptive reuse in Lethbridge looks very different than in capital markets. Being such a small market, commercial real estate in Lethbridge has the agility to adapt existing space based on emergent needs within the community. Changes to the office environment and user mentality during the pandemic led to office space having high vacancy and being more readily available, often at a lower rate than other asset classes. As such, office space is more affordable and has become a practical option for non-traditional users such as medical use and social services. Even users who are not typically office occupiers may opt for vacant office space because of the lower costs of adapting the space when compared to new builds.

“Childcare and social services are increasingly redeveloping office space that they wouldn’t traditionally occupy, because they are able to utilize a portion of the existing buildout and reduce costs.”

**- Ashley Soames,
Senior Associate**

Additionally, new office space in Lethbridge has been built primarily in mixed-use developments with office, retail, and residential offerings operating side-by-side. Although B- and C-class office spaces with high vacancies are less expensive, they are less desirable for office users who are prioritizing the quality of their space.

Canada office vacancy (%)



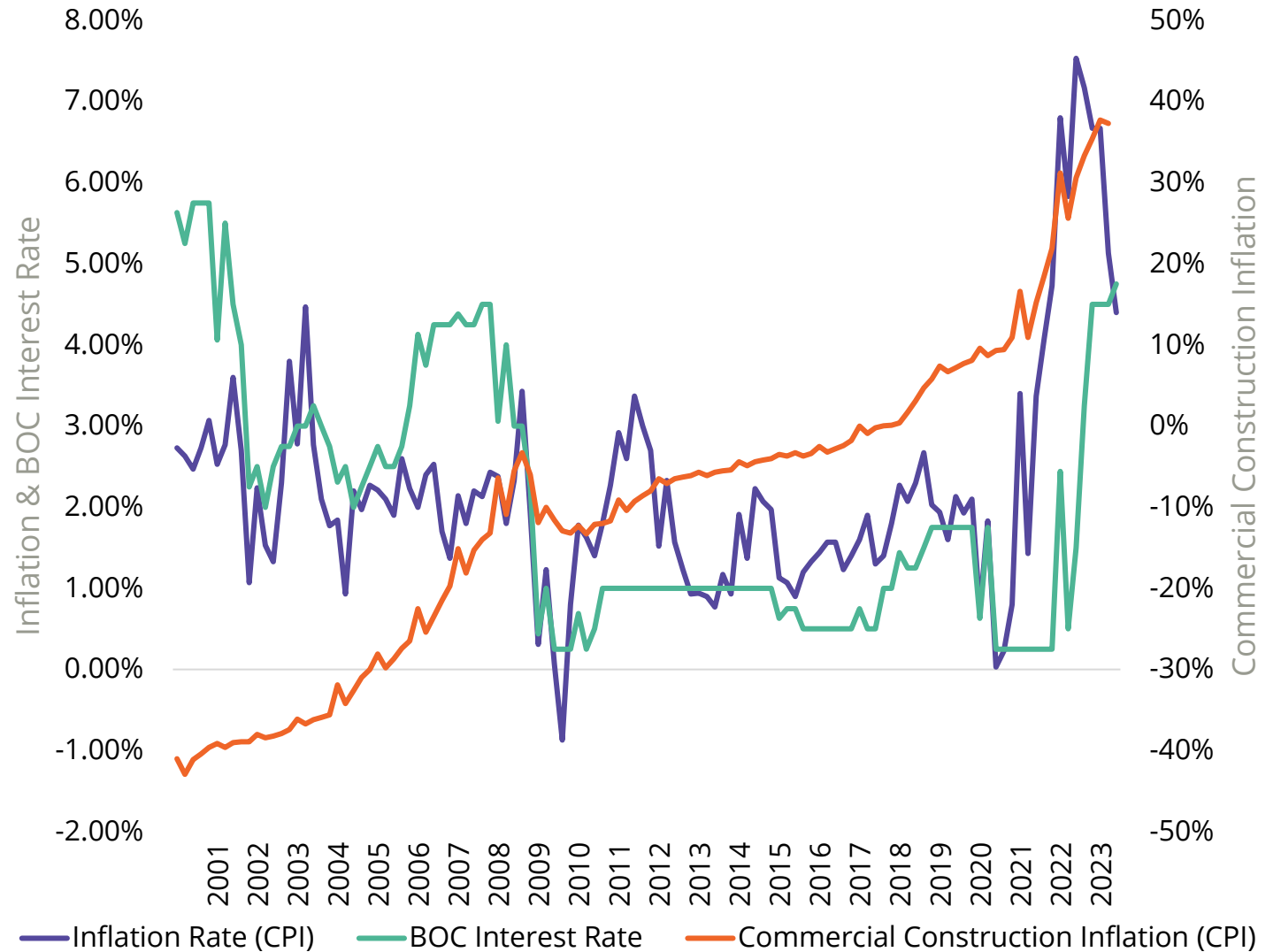
Costs of new builds

Office buildout prices in Lethbridge have effectively doubled the pre-pandemic average.

Non-residential building costs in Canada have risen 11.1% year-over-year as of the end of 2022. Shortages and inflation of materials were most acute in fuel, concrete, and steel. While fuel prices have stabilized, concrete, steel, and built components such as HVAC units, are still contributing to a slowdown in new builds. When CPI inflation upticked slightly in April from 4.3 to 4.4% after being predicted to continue to fall, it prompted the Bank of Canada (BOC) to raise interest rates from 4.5% to 4.75% on June 6, 2023. Because there is a delay between interest rate increases and their effect on the market, some analysts see the BOC rate increase as too reactionary and possibly detrimental to market sentiment; especially considering CPI inflation dropped to 3.4% in May. Similarly, lending parameters are continuing to tighten, making it harder for new builds that are applying for loans based on estimated costs in an unstable market.

In Lethbridge, inflation has driven up the cost of new construction and slowed investment in new development. This is most prevalent in office build-outs from shell space. For example, the cost to build out medical office suites from shell was approximately \$100-110.00 per-square-foot (psf) four years ago, but now a basic office built from shell is around \$200.00 psf.

Inflation vs. interest rates (%)



*Statistics Canada records Commercial Construction CPI rate as a % relative to 2017

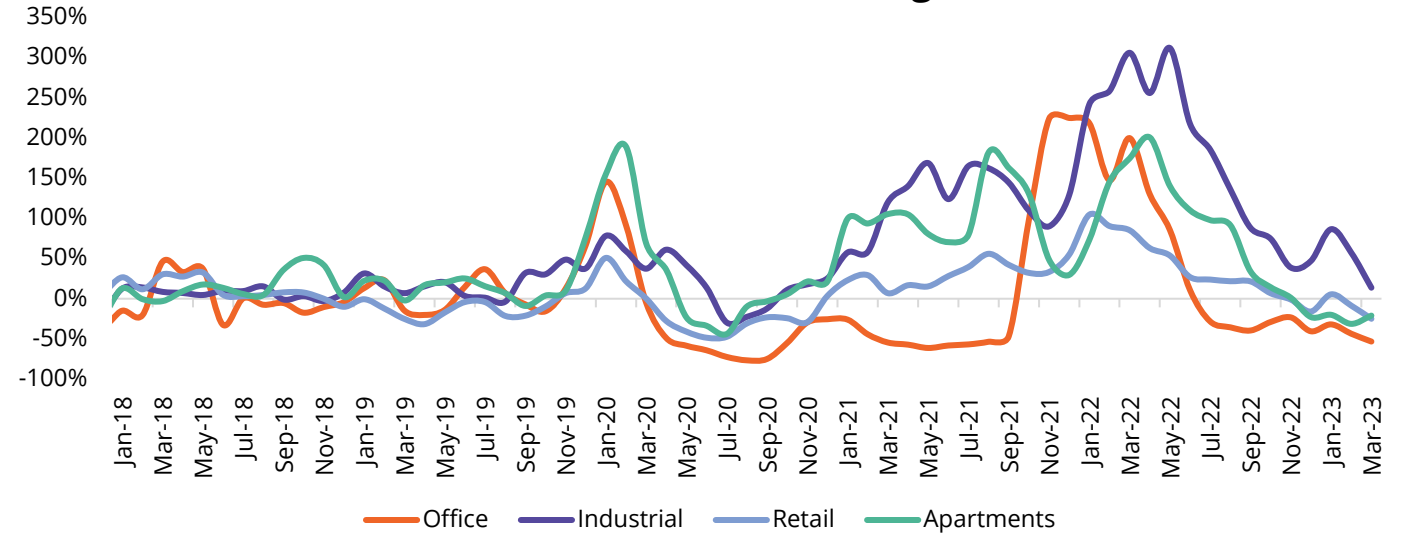
Office investment

National sentiment and local perspective.

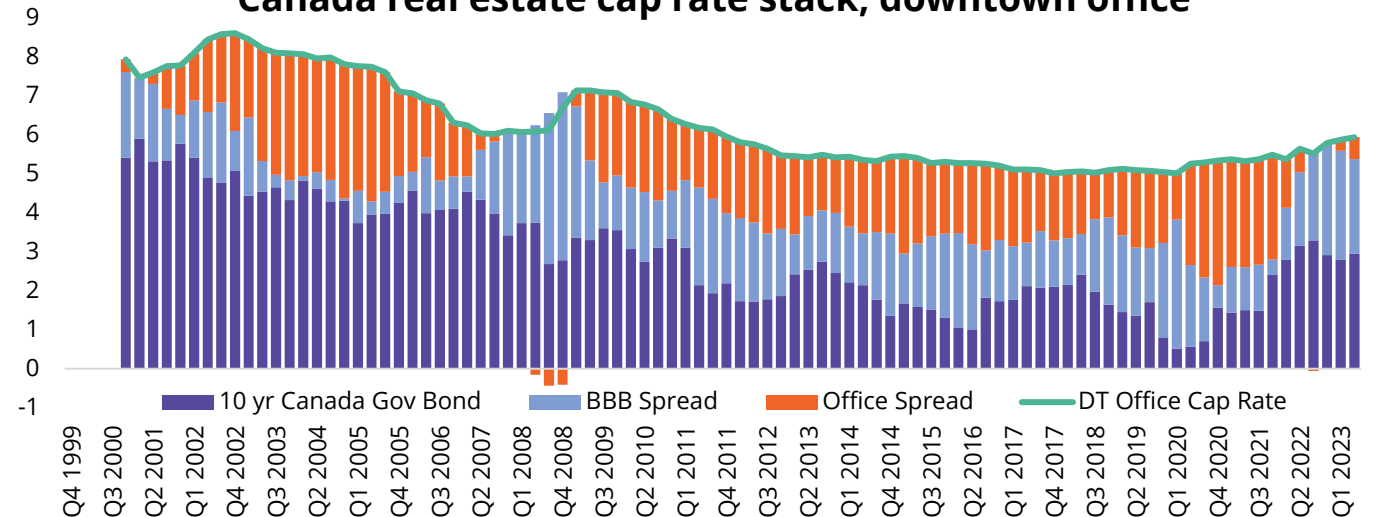
Nationally, office investment is down -53% relative to the 2016-19 average, and vacancy is at historical highs. With higher risk spreads between the BBB spread and the cap rate, investors are either continuing the holding pattern on office investments seen at the end of 2022 or deciding to move forward at a higher risk premium. Office investment in Lethbridge has historically been fairly minimal, with most purchasers being owner-users who are looking to invest in their own space to control costs and build equity. As such, developers will often meet demand by dividing office buildings into purchasable condos instead of leasing.

With high vacancy, B- and C-class office investment sales are generally facing higher cap rates and lower yields. Few transactions in the market also make it difficult to provide comparables to support higher asking prices. Additionally, provisional leases, or leases that made concessions through the COVID-19 pandemic, are affecting the sale value of investment properties now. Year-over-year growth targets are lower than originally forecasted and significantly down from 2022. However, cap rates are not reflecting the current cost to build; existing office space now has a higher per-square-foot value than new builds because of inflated construction costs. Similarly, average office lease rates in Lethbridge have remained steady. In the near future, cap rates could strengthen based on the value of renewals.

Canada rolling 3 M investment transaction volume Relative to 2016-19 average (SA)



Canada real estate cap rate stack, downtown office



The future of work

Demand for hybrid work and coworking spaces.

Work-from-home mandates during the pandemic necessitated the widespread adoption and acceptance of hybrid work. While there are mixed perceptions of the productivity of hybrid work, over in-person collaboration, many employees and many employers have embraced this new model. The Government of Canada set the standard with the implementation of a hybrid work model as of March 31, 2023, where approximately 262,000 federal public servants can work from home 2-3 days a week, or 40-60% of their regular schedule. However, affiliated agencies did not adopt the strategy, which then became a keynote issue of the April 2023 general strike. Although the strike failed to ratify contractually guaranteed flexible work, it shows how deeply entrenched the mentality shift has become.

Coworking spaces have gained more traction in many markets, offering opportunities for office users with variable needs, small staffs, or streamlined budgets. In Lethbridge, coworking spaces include The Port, which has been operating since 2019, and The Post Hybrid Workspace, which had its grand opening on May 24, 2023. These unique spaces allow office users to primarily work-from-home while having a public-facing space for collaboration, client meetings, etc. Smaller organizations can keep their overhead and footprint low while retaining the benefits of a professional workspace.



City of Lethbridge Demographics

Population

106,550

West Lethbridge

▲ 2,895 people (7.08%)

North Lethbridge

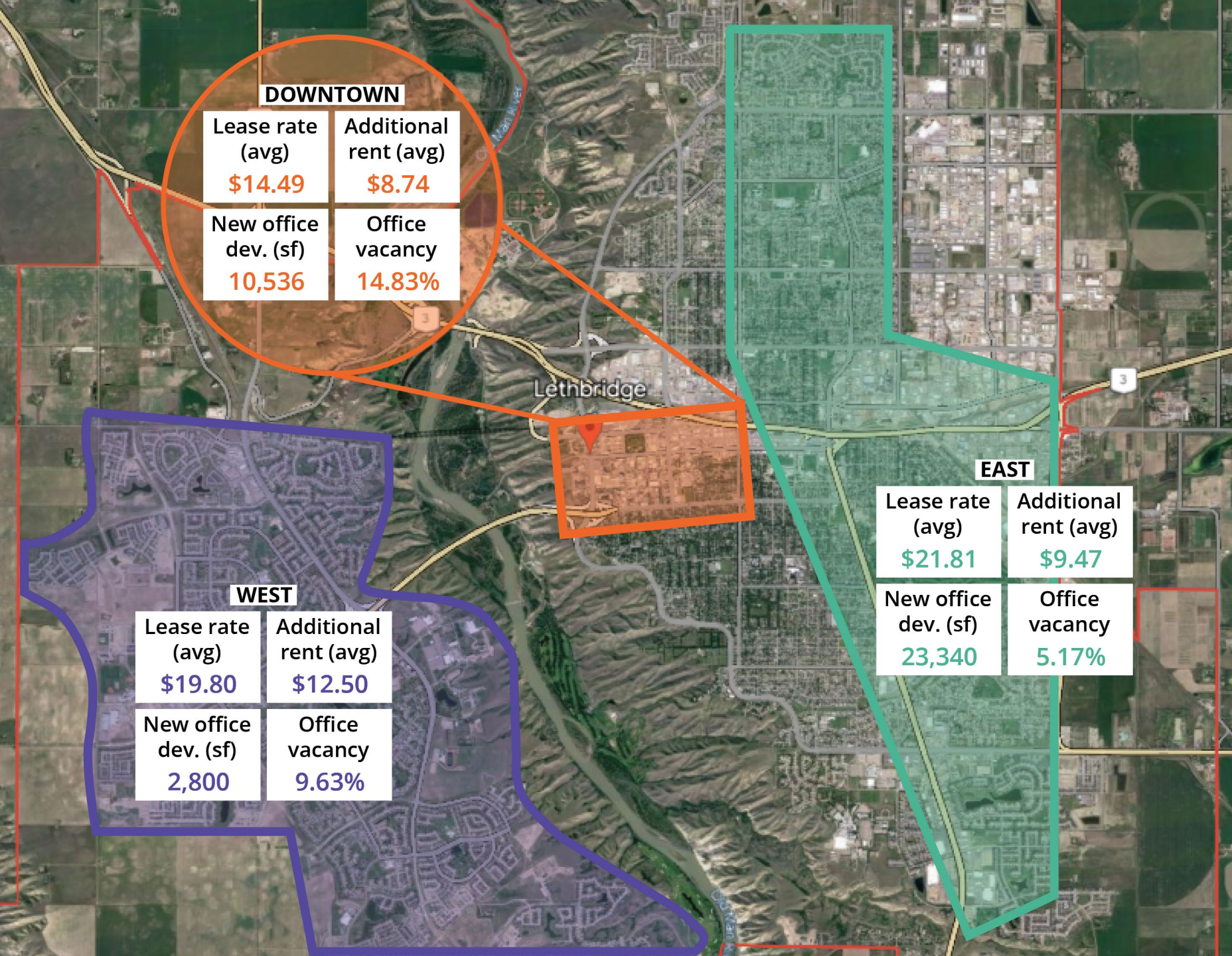
▲ 1,276 people (4.53%)

South Lethbridge

▲ 897 people (2.77%)

*Growth rate from 2019 – 2023
Source: 2023 Census

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Lethbridge in 2023

The sentiments of office tenants and owner-users have shifted from a price per-square-foot motivation to a **focus on the quality of the office space** and amenities. While the 'return to work' in Lethbridge does not face the challenges of primary markets, office users are simply demanding more when it comes to a space that supports their corporate culture and employee retention. With low unemployment and the possibility of a "forever labour shortage," according to Business Insider, the future of office demands continues to prioritize employee satisfaction through flexible work and desirable spaces.

"Spaces are being designed to accommodate the needs of the employee with the intention of enhancing the office culture of the business itself through amenities and design elements."

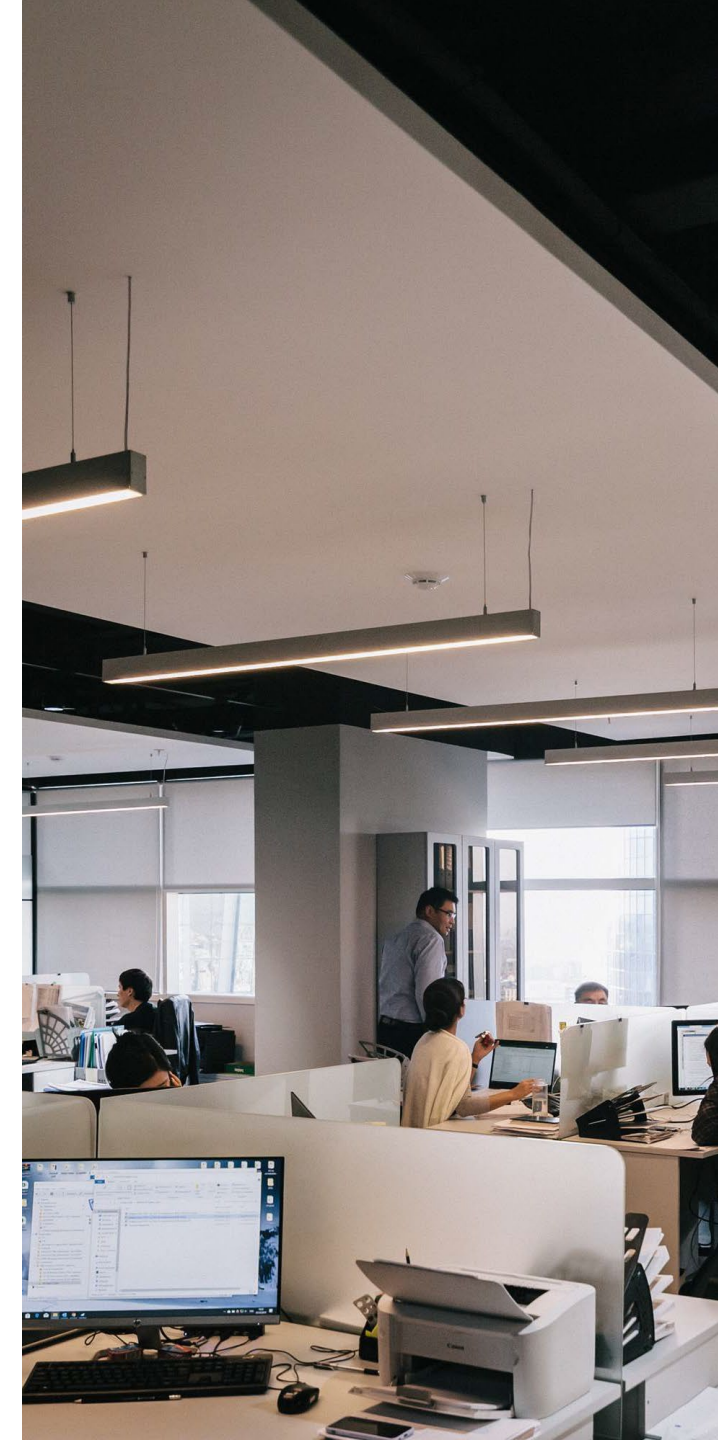
**- Jeremy Roden,
Executive Vice President**

Adaptive reuse in Lethbridge does not follow the trend of capital markets due to its population and local demand. While conversion of office space to residential boosts foot traffic and creates '15-minute cities' in large centres, Lethbridge is small and accessible enough that downtown businesses are not dependent on office foot traffic and with the current inflated construction costs, major projects just don't make sense. Instead, some office real estate in Lethbridge is being adapted by non-traditional users.

Inflation and the cost of new builds have drastically affected developer and investor sentiments. The Canadian GDP has performed much better than expected, which makes it more challenging to bring down inflation. With the latest interest rate increase of +0.25%, the BOC is still attempting to counter inflation rather than holding the rate for the market to correct. Construction costs may ease as the Canadian economy slows, but with skeptical investors, conservative banks, and tight employment rates, the moderation of inflation may take time to reach our market.

Closing thoughts

Although the office commercial real estate market is facing high vacancy and challenging market conditions nationally, Lethbridge has a lot of reasons for a positive outlook in 2023. The continued growth of our local market, and provincial and national GDP, means that demand for office services continues to be present in our market. With the 'flight to quality' mentality, existing B-and C-class spaces are encountering a demand for significant improvements. Until costs better align with demand, office space is instead being reimaged by non-traditional users as a lower-cost alternative. Lethbridge has seen positive net absorption and maintained steady lease rates with moderate increases. We are optimistic for what the future of office real estate will look like in our city.



For more market insights
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