SPECIAL REPORT

TD Economics

July 12, 2012

# CANADA'S COMMERCIAL REAL ESTATE MARKETS PRIMED FOR GROWTH

### Highlights

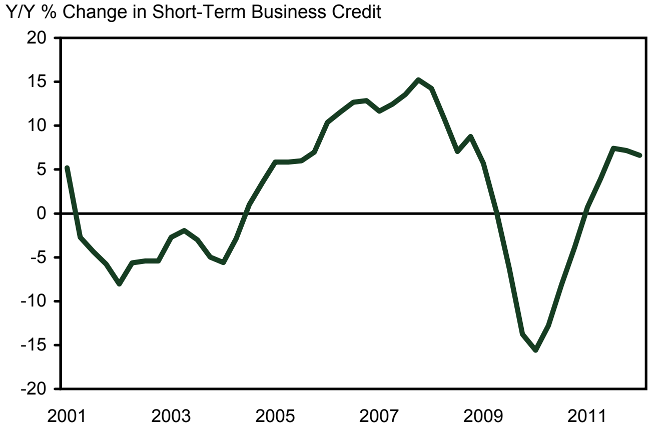
- The run up in residential housing activity and the ensuing overvaluation incorporated in prices has led headlines to concentrate solely on the residential side of the real estate market. Chugging along more silently in the background has been a commercial market which has once again found its footing after being hit hard by the 2008-09 recession.
- In 2011, Canadian commercial real estate put forth an impressive showing to return to pre-recession volume and activity levels – over $21 billion assets changed hands.
- After the stellar showing last year, we expect transaction volume to moderate in 2012. That being said, supportive factors will still be present – favourable borrowing environment, corporate profits advancing by 4.3% this year, and healthy cash reserves for firms. The wild card to the second half of 2012 will be consumer and business confidence given the current risk-filled economic climate.
- With demand elevated post-recession and many developers waiting to see if global risks abate, most property classes (office, retail and industrial) remain fairly tight. To help ease this pressure, we anticipate a new construction cycle will take place over 2013-14.
- Demand for high-quality commercial office space continues to outpace supply in Calgary and Edmonton. This trend will persist into 2013 as there are only a handful of office projects currently under construction in both cities. Industrial real estate demand should also liven up in 2013 when crude oil prices return to US$90 at the beginning of 2013.
- Toronto is also experiencing tight conditions, thanks to renovations in the financial core and heightened demand for mixed-use development associated with condos. Several projects under construction will bring 4 million square feet of commercial space to the market over the next few years.

Recent developments in commercial real estate here in Canada have been largely overshadowed by trends recorded by its residential cousin. However, the commercial side of the market has recorded quite a comeback from the troughs posted in the early part of the recovery. In fact, over $21 billion dollars in commercial real estate assets exchanged hands last year, nearly $10 billion more than the tally recorded in 2009.[1] What's more, a short supply of projects and even demand has allowed most regional markets and property classes to tighten over the past 12-18 months.

The tighter conditions would lend itself to a new round of projects. We are already seeing development intentions materialize – there are renovation plans in major shopping mall centres across the country and there are an elevated number of new office towers being built. For example, there are sixteen office towers currently being constructed in Toronto, bringing 4 million new square feet over the next 3-4 years. While ongoing global financial uncertainty is likely to remain a challenge, steady economic gains in Canada – combined with continued low interest rates – should be supportive to commercial project development. Thus, after a modest tightening for much of 2012, we forecast that Canadian commercial real estate is primed for growth. In turn, we anticipate a new cycle of construction to occur over 2013-14.

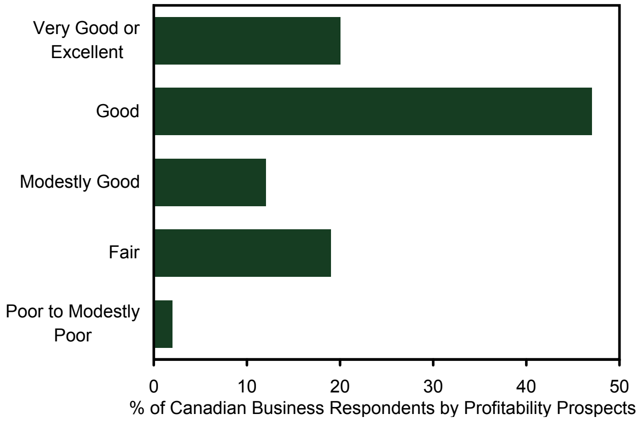
Sonya Gulati, Senior Economist, 416-982-8063

CREDIT CONDITIONS FOR BUSINESS SHORT-TERM LENDING HAVE IMPROVED



Sources: Bank of Canada, Haver Analytics.

MOST CANADIAN BUSINESSES ARE EXPECTING 2012 TO BE A PROFITABLE YEAR



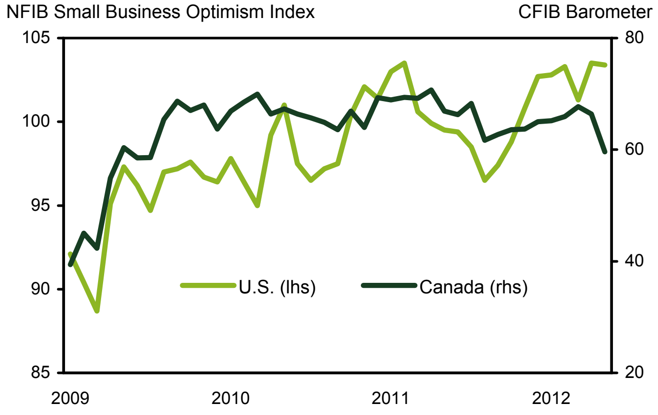
Source: Emerging Trends in Real Estate 2012 Survey: PwC and Urban Land Institute.

### Taking stock of the recent performance

While financial market volatility was a dominant theme for much of 2011, Canadian commercial real estate was able to shake off any nerves or unease. The $21 billion transaction volume in 2011 could be chalked up to post-recession demand for commercial space.[1] Office markets saw their vacancy rates decrease to roughly 8.0% and rents per square foot for high-quality units are $17-23, depending upon downtown or suburb location. These levels are just shy of where they were heading into the recession.

From a macro perspective, commercial real estate demand also stems from the relative safety of the Canadian market, as compared to other countries. Low interest rates also created a favourable borrowing climate for those firms financing their purchase with a loan and/or through debt issuance. The domestic economy returned to pre-recessionary employment levels mid-way through last year, and churned out an average 22,000 net new positions per month in 2011. In spite of growing household debt, real consumer expenditure gains (4.0%) were also robust. Both of these indicators are proxies for office and retail space demand. Pre-tax corporate profits advanced by 15%, year-over-year, in 2011 and firms were sitting on healthy cash reserves, as evidenced by domestic and foreign currency holdings and non-personal deposits.

CONFIDENCE LEVELS HAVE HAD THEIR FAIR SHARE OF UPS AND DOWNS



Sources: National Federation of Independent Business (NFIB); Canadian Federation of Independent Business (CFIB).

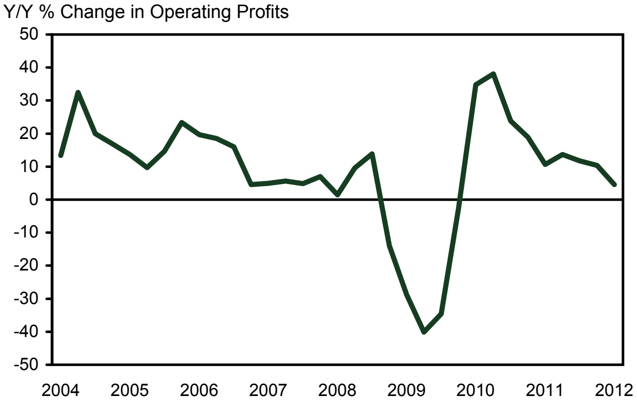
The first quarter transaction data indicate that 2012 received a solid hand off from 2011. Depending on the data source, the national office vacancy rates are in the high 7.0s%, a few tenths of a percentage point below the end-2011 figures. Availability rates (which represents the amount of property that is currently available for lease or may soon become vacant) for the industrial property class are also down by the same margin to start 2012. This backdrop and recent trends suggest that demand for commercial space has held up so far this year.

### Supportive factors in place, but risks loom large

In our Quarterly Economic Forecast publications released last month (Global, U.S. and Canada), we compiled a series of baseline assumptions surrounding the near-term global and Canadian economic forecast:

- Global economic growth should come in at 3.1% in 2013, a subdued pace which leaves little room to absorb any further shocks. Our forecast assumes that European leaders take sufficient action to prevent financial conditions from worsening and spreading globally. In other words, Europe should muddle through its debt crisis over the near-term.

CANADIAN CORPORATE PROFITS HAVE STARTED 2012 ON A WHIMPER



Source: Statistics Canada/Haver Analytics.

- Uncertainties surrounding fiscal policy will serve as a headwind to U.S. economic growth in the coming months due to the scheduled expiry of temporary U.S. tax cuts and the automatic spending cuts set to kick in. We expect that private sector demand will partially offset this weakness, helping to keep the U.S. economy growing at roughly 2% this year and next.

- The Canadian economy is transitioning into a period of softer economic growth of around 2%. Consumers and governments will no longer be the driver of growth that they once were because both are now saddled with large debt burdens. Instead, businesses and exporters will carry the baton going forward.

We should recognize that downside risks to the global economic recovery have re-intensified over the last few months. There are renewed concerns about financial market contagion surrounding the European sovereign debt crisis. Worries are also present about the probability of a greater than-anticipated slowdown in China and other emerging markets and the implications of such an event for commodity prices. If these risks were to materialize, they would have negative consequences for business confidence and the appetite for commercial property. More specifically, the resilience the market has recently displayed will undoubtedly wear thin if risks continue to intensify and/or if an economic shock were to hit Canada.

With risks acknowledged and in light of steady but modest economic growth, all signs point to the commercial real estate embarking on a new development cycle in 2013-14. This is because supply needs to come online to help ease some of the tightness that many urban centres are experiencing. This desire to bring new projects to light has been corroborated in recent surveys such as Statistics Canada's Private and Public Investment Survey. Economic data in the months since the survey results were published might have muted some of this intent, but there is an underlying desire to add new supply to the market. We suspect that some developers and firms will wait a bit to see if the current financial market volatility and economic uncertainty abates, before embarking on any large-scale, new projects.

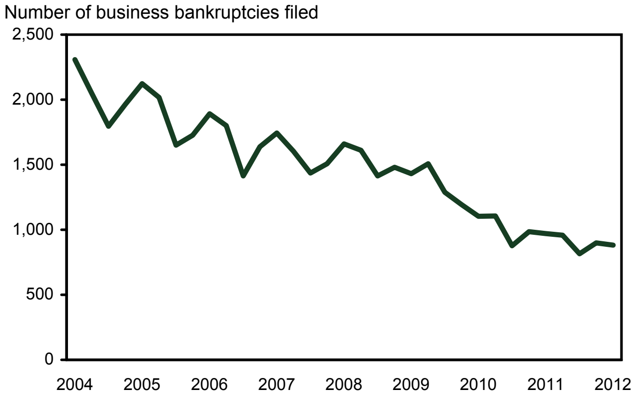
While the Canadian commercial property segment is often thought of as homogenous, it cannot be painted with a single brush. Instead, property classes such as office, industrial and retail must be viewed separately, as each is starting from a different degree of tightness. Influencing factors and recent developments might also be more pertinent to one class versus the other. In the next three sections of this report, we present our near-term outlook for each of these property classes.

### Office – Western Canada still drives demand train

Canadian office fundamentals have been steadily improving since the onset of the recovery. Last year, the market absorbed roughly 8 million square feet of new inventory, which when compared to the decade long average, is healthy, but much lower than the 16.5 million square feet absorbed during the first part of the economic recovery.

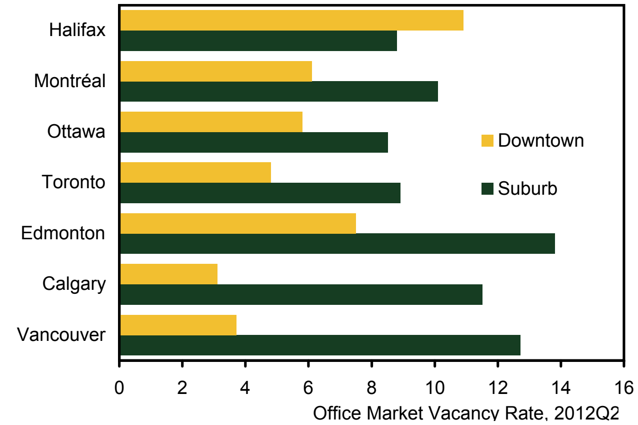
Market tightening and declining vacancy rates were noticed for office properties: six out of the seven major markets (Vancouver, Calgary, Edmonton, Toronto, Ottawa and Montréal) are showing vacancy rates well below the national average of 8.0%. The Western hubs of Calgary and

BUSINESS BANKRUPTCIES IN CANADA CONTINUE TO TREND DOWN



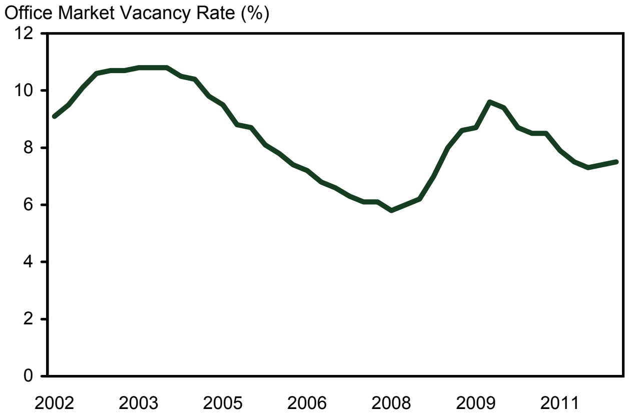
Note: Bankruptcies recorded across all industries is presented.
Source: Statistics Canada/Haver Analytics.

**DOWNTOWN OFFICE VACANCY RATES ARE LOWER THAN SUBURBAN COUNTERPARTS**



Source: Cushman and Wakefield

**NATIONAL OFFICE VACANCY RATES APPEAR TO HAVE STABILIZED**

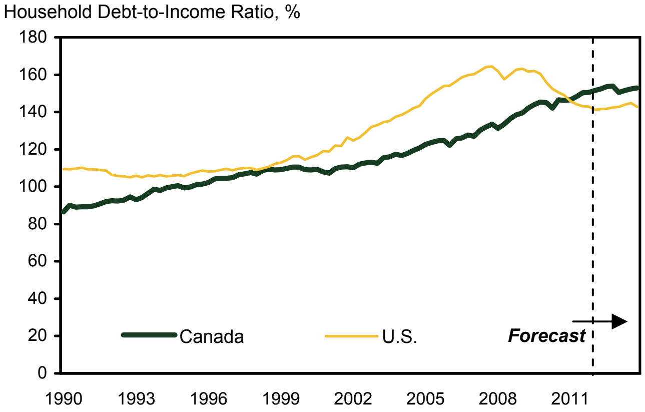


Source: CBRE Canada, Commercial Real Estate Services

Edmonton witnessed the greatest demand for high-quality office space given investment intentions in the oil and gas sector. The expansion of financial services helped keep demand levels high in the Toronto area.

As can be seen in the accompanying chart above, there is also a noticeable geographical divide in office market vacancy rates: the downtown areas of the urban centres have a much tighter market versus a comparable suburban office location. This trend has persisted for some time, as businesses tend to locate in the central district to gain access to a high-quality labour force. In addition, there may be spill-over effects from setting up shop close to one's competitors and/or suppliers situated downtown. The data indicate that there has been a greater degree of urbanization among businesses in recent quarters. This phenomenon is most evident in cities like Vancouver and Calgary.

**HOUSEHOLD DEBT BURDEN FOR CANADIAN CONSUMERS EXPECTED TO GROW**

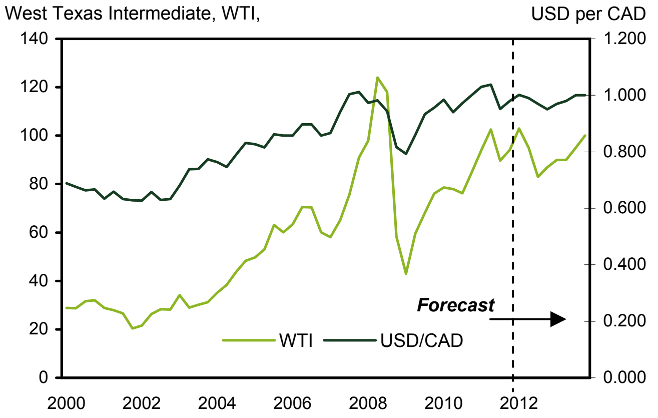


Sources: Statistics Canada, Federal Reserve Board, Haver Analytics. Forecasts by TD Economics as at June 2012.

If we look out to the rest of 2012, the vacancy rate should move lower across most regional office markets. While the downward trend is indicative of tightening conditions and demand exceeding supply, the rate is still higher than the 6.0% range which prevailed before the recession.

There is approximately 7.6 million square feet of new space under construction, the bulk of which is set to occur in downtown areas. Given that much of this space will not be completed for a few years, the new supply will likely be insufficient to meet demand levels over the near term. Demand exceeding supply will put upward pressure on rents. As such, elevated rents are expected across all quality grades, given the desire for high-quality space and the number of people willing to backfill the vacated units. The suburbs should also record some of these rent gains, as firms look to snatch up space at cheaper rates than what can be found downtown.

In light of our commodity price profile and non residential construction investment intentions, we forecast that Calgary and Edmonton will help boost demand for high-quality office space over the medium-term. Federal and provincial government austerity measures should temper demand for office space in both Ottawa and Toronto. However, other sectors in the region, such as the high-tech sector in Ottawa or the financial sector in Toronto, might offset the reduced public sector appetite. In Halifax, demand for office space is ramping up in preparation for work to get underway on the multi-billion, multi-year shipbuilding contract.



HEADWINDS IN PLACE FOR THE MANUFACTURING SECTOR

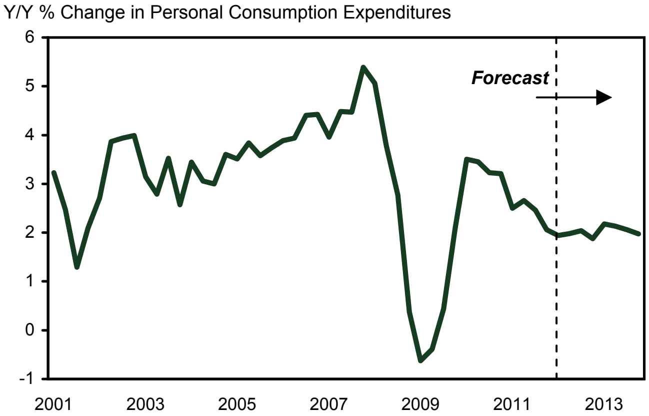
Sources: Statistics Canada, Haver Analytics.
Forecasts by TD Economics as at June 2012.

### Retail – Juggling foreign retailer demand with domestic consumer fatigue

The Canadian retail real estate market is taking a bit of a breather from a revival of foreign retail demand. Last year, U.S. based retail chains such as J. Crew and Marshalls set up shop on this side of the border. Almost all major urban centres saw these chains arrive, given their close proximity to transportation and logistics hubs and their share of the Canadian population. Condo projects in big cities are also driving commercial development in the downtown areas. For example, many condo projects have some space reserved for retail shops at the lobby level.

Looking ahead, Target is not expected to land in Canada until next year. Management at the discount retail giant have stated that they plan to open 200 stores across the country, reaching $6 billion in sales in six years. In the federal government's recent ruling under the *Investment Canada Act*, Target has agreed to  employ 100-200 people per store in Canada. This means 20,000-25,000 employees nationwide by 2015. Last but not least, the U.S. retailer has committed to spend more than $3.5 billion in capital investment on this side of the border.

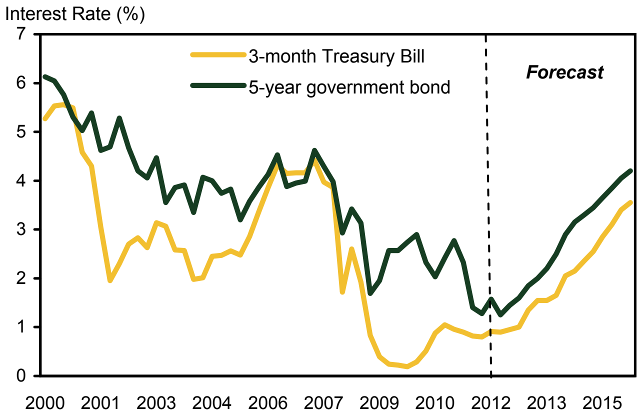
Many of the early Target stores will come in the form of lease takeovers of Zellers space. In all, 125-135 former Zellers stores will be converted to Target locations. Therefore, we do not anticipate a surge in new retail supply with Target's arrival next year. Even so, retail developers and property managers are already seeing heightened demand across most retail formats (e.g., street front, mall, chain stores) for leases near Target's future location. These outlets are looking to gain benefits such as steady foot traffic associated with Target clientele.



PACE OF CONSUMER EXPENDITURE EXPECTED TO BE MODEST OVER 2012-13

Sources: Statistics Canada, Haver Analytics.
Forecasts by TD Economics as at June 2012.

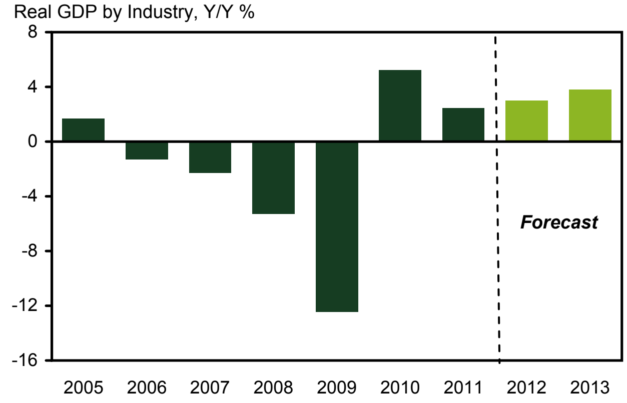
We do not have real estate data on how 2012 has performed year to-date, but we can get a sense of overall performance through retail sales data. Retail sales, at the national level, are coming in at 4% on a year-over-year basis, well below the 6-7% seen before the recession and in the early part of the recovery. The recent data, combined with trends in household debt accumulation, suggest that Canadian consumers are beginning to cool their pace of spending to about half of their trend rate. With this in mind, the near-term retail performance will be weighed down by several factors, including: rising household debt, muted income growth, consumer fatigue, and uncertainty about the interest rate profile.



INTEREST RATES EXPECTED TO GRADUALLY INCH UPWARDS

Source: Haver Analytics. Forecast by TD Economics as at June 2012.

**MANUFACTURING SECTOR TO BENEFIT FROM HEIGHTENED BUSINESS INVESTMENT ACTIVITY**



Source: Haver Analytics/Statistics Canada.
Forecast by TD Economics as at June 2012.

| COMMERCIAL REAL ESTATE INDICATORS | | | |
|---|---|---|---|
| | 2010 | 2011 | 2012E |
| **Office Property Class** | | | |
| Vacancy Rate (%) | 9.4 | 8.2 | 8.0 |
| Downtown Class A Rent ( $ psf) | 23.9 | 23.3 | 24.0 |
| Suburb Class A Rent ( $ psf) | 17.3 | 16.9 | 17.2 |
| **Industrial Property Class** | | | |
| Availability Rate (%) | 7.4 | 6.5 | 6.4 |
| Rental Rate ( $ psf) | 5.5 | 5.4 | 5.5 |
| Manufacturing Sector GDP (%) | 7.0 | 3.0 | 3.1 |
| **Retail Sales (%)** | 5.5 | 3.6 | 3.0 |
| **Real GDP (%)** | 3.2 | 2.4 | 2.1 |
| **Unemployment Rate** (%) | 8.0 | 7.5 | 7.4 |
| **Employment (%)** | 1.4 | 1.5 | 1.1 |

psf: per square foot
E: Estimate by TD Economics as at June 2012.
Sources: CBRE, Conference Board of Canada, Haver Analytics.

The western markets of Calgary and Edmonton should see a better retail performance given their above-average income and employment gains. Ottawa, Toronto and Montréal are likely to be at the other end of the spectrum given muted economic prospects. In addition, all three cities will feel the economic impacts of government austerity measures such as higher provincial sales tax rates, civil servant cuts and/or broader public sector wage freezes. Halifax should come in towards the middle of the pack, as the city preps for shipbuilding work to begin in 2013.

The decision to enter Canada was made by foreign retailers a long time ago. However, they will likely take their cue from the economic and consumer climate, in how they should roll out locations across the country. The same can be said for domestic retailers as well. What's more, concern about consumer willingness and ability to spend in the event of another period of economic and employment uncertainty must also be taken into consideration.

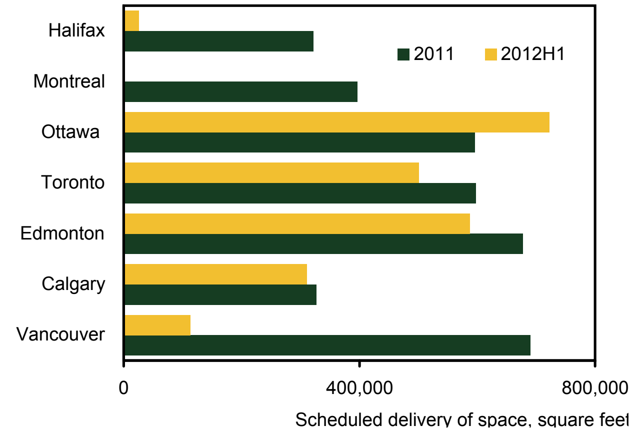
## Industrial – Sensitive to developments abroad

The industrial portion of the Canadian commercial market was hit particularly hard by the 2008-09 recession. This is not surprising as many units and/or operators are tied to the natural resource and manufacturing sectors, both of which experienced out-sized losses in jobs and corporate profits. In comparison to the office and retail segments, the industrial class has experienced a more gradual recovery. Net absorption has been modest over the past few years, reflecting the prevailing economic uncertainty and the tepid pace of the U.S. recovery – our largest trading partner. Project plans suggest that developers are also opting to consolidate existing units as opposed to leasing new space. This development activity bites into the net new absorption figures reported.

The national availability rate in 2011 was about 6.5%, well down from recession highs of 7-8%, but still above the 5-6% rates that prevailed before the recession. These statistics demonstrate the gradual healing that continues to take place, even two and a half years after the recession. Developers have also been wary to start new projects – roughly 7 million square feet of space were added last year, slightly below long-run averages.

Data for 2012 suggest that the industrial market picked up exactly where 2011 left off. In fact, given the current risks, there has been a significant amount of worry about the health of the economic recovery. We suspect that this tempered demand has relieved some of the pressure on rental

**REGIONAL DIFFERENCES IN INDUSTRIAL COMMERCIAL REAL ESTATE MARKET**



Source: CBRE Canada, Commercial Real Estate Services rates. Year-to-date, we estimate that the vacancy rate has edged up by a few tenths of a percentage point, with rents moving in the other direction.

There are many headwinds clouding the near-term industrial real estate outlook which we outlined earlier in the report. That being said, manufacturing activity appears poised to record decent growth in 2012 and in 2013, led by a cyclical rebound in the auto sector. Still, levels of activity will continue to remain well below those numbers prior to the run-up in the Canadian dollar which began in the early 2000s. The wholesale trade sector and transportation and warehousing sector will lift industrial demand for real estate going forward. This is because each of these sectors are poised to see higher GDP growth in 2012 and 2013 than the national average.

In light of the supporting factors and the challenges present, we anticipate that the industrial segment will continue to broaden in scope – we have already seen a shift away from manufacturing towards other specializations like transportation, logistics and distribution. These diversification efforts help reduce exposure to global developments. Still, industrial tenants and market movements remain tied to the highly cyclical manufacturing and natural resource sectors.

As economic conditions gradually improve, demand for industrial space should continue to perk up. We anticipate strength across the country in 2013-14. The western markets will be lifted by reasonably-high commodity prices, oil sands development and non-residential construction investment. Central Canada will also benefit as the U.S. economic recovery gains traction and their pent-up demand for consumer goods is unleashed. The Atlantic may receive some spill-over benefits from the oil and gas sector and shipbuilding work getting underway in Halifax. In light of these favourable prospects, we expect industrial developers to look to bring high quality space to the market across the country to meet the demand.

### Urban markets tell the story

We presented our thoughts and analysis on commercial real estate by property class as each segment deserved to be reviewed on its own. We must do this same exercise by region as there really is no such thing as a national market. Seven urban centres (Vancouver, Calgary, Edmonton, Ottawa, Toronto, Montréal and Halifax) are explored in detail next.

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## VANCOUVER – SUBURBS BENEFIT FROM OFFICE SUPPLY CONSTRAINTS

The office market has tightened in Vancouver since the initial part of the recovery. The overall vacancy rate has decreased by about 3 percentage points over 2010 and 2011 to rest at about 7.5%. Rents have also bounced back – they come in $3 higher than the levels which prevailed in 2010. These numbers indicate that Vancouver is in a tighter position than the national picture, where the vacancy rate and average rent per square foot are 8.0% and $24, respectively.

As of the first quarter of 2012, there were seven new office buildings under construction, but it will take a few years for this space to reach the market. In the interim, there will be little new supply in the downtown core to ease conditions until next year at the earliest. With elevated demand and limited supply, downtown vacancy rates will hold steady in the 3-3.5% range, or about half the national rate. Rents will edge up slightly given the underlying conditions and the geographical limitations preventing new space from quickly popping up. These moves will bring downtown Vancouver closer to where it was prior to the recession.

Suburbs have helped soak up some of the excess demand for office real estate. Helping to lure developers and tenants to the suburbs is the higher vacancy rate (13.5%). Suburban rents are also cheaper, by as much as $14 per square foot, versus a comparable site downtown. Land availability also makes the suburbs a more attractive location for large site occupants. So far this year, high-quality space (Class A units) has seen the largest spike in demand, a trend which we expect to continue over the near-term. However, rents will gradually increase across all quality types, as people move up in quality and back-fill demand persists.

### Population growth a proxy for retail demand

A proxy for retail space and demand is population growth. According to recent Census results, the Vancouver regional population grew by 9.3% from 2006-2011. This is not the fastest pace the region has ever recorded, but it does suggest there are opportunities for retail developers to capitalize upon. Also, there are some pockets of high net worth clients, and retailers are looking for the best way to bring this clientele to the stores. Residential housing overvaluation and high household indebtedness will serve as headwinds for retail sector activity over the near-term, limiting retail spending to a modest clip.

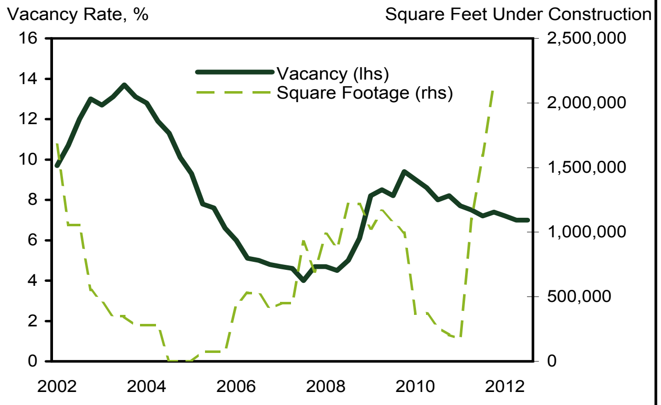
| VANCOUVER, BRITISH COLUMBIA<br>COMMERCIAL REAL ESTATE INDICATORS | 2010 | 2011 | 2012E |
|---|---|---|---|
| **Office Property Class** | | | |
| Vacancy Rate (%) | 8.8 | 7.7 | 7.2 |
| Downtown Class A Rent ( $ psf) | 30.6 | 33.5 | 33.9 |
| Suburb Class A Rent ( $ psf) | 21.0 | 19.8 | 20.5 |
| **Industrial Property Class** | | | |
| Availability Rate (%) | 8.6 | 7.1 | 6.9 |
| Rental Rate ( $ psf) | 8.1 | 7.6 | 7.8 |
| **Retail Sales (%)** | 4.6 | 1.8 | 3.1 |
| **Real GDP (%)** | 4.0 | 4.2 | 2.9 |
| **Unemployment Rate** (%) | 7.5 | 7.3 | 6.4 |
| **Employment (%)** | 1.3 | 2.6 | 3.5 |

psf: per square foot

E: Estimate by TD Economics as at June 2012.

Sources: CBRE, Conference Board of Canada, Haver Analytics.

VANCOUVER COMMERCIAL OFFICE MARKET



Source: Altus InSite. 2012 Estimate by TD Economics as of June 2012.

For the retail segment, supply appears to be in line with demand this year. As foreign chains continue to eye the Vancouver area, new space will be added, particularly in the suburbs given the more favourable rental rates and greater availability. It is estimated that there is 2.5 million square feet of new retail space under construction. With demand waning and new supply being added, the retail class should loosen in 2013.

### Industrial class sensitive to risk-filled environment

Like the national picture, the industrial class will be sensitive to developments abroad. In Vancouver's case, the health of the Chinese economy will be of particular interest, given the trade linkages between the Canadian city and the world's number two economy. Assuming that China's economy only experiences a moderate slowdown – as we expect – the industrial class in Vancouver should see vacancy rates hold steady throughout the second part of the year. Limited supply and few available options serve as constraints in this segment; rents ought to rise to roughly $7.80 per square foot. In light of ongoing concerns surrounding the potential for a hard-landing in China, a new industrial construction cycle is not anticipated until late-2013. At that point, the suburbs should benefit from most of the new supply given their ability to meet large-site occupancy demands.

## CALGARY – COMMERCIAL CLASS BUOYED BY OFFICE DEMAND

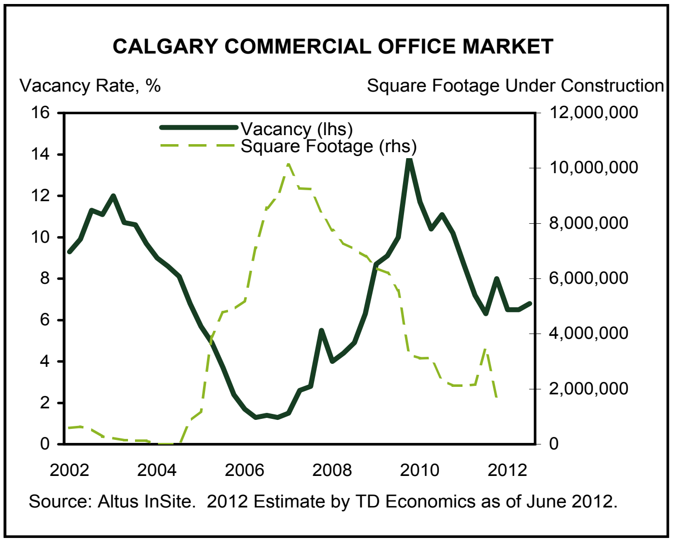
About 40% of the world's publicly-traded energy companies have their headquarters set up in Calgary. Roughly two-thirds of the downtown office space is occupied by energy firms. With crude oil prices staying firm throughout much of last year, all property classes recorded an improvement in conditions and higher transaction volumes. Each class was also benefiting from the cyclical rebound in economic and employment growth that ensued following the recession.

The office segment, in particular, has realized gains over this time frame. A case in point, vacancy rates currently sit at about 7.5%, well below the statistic that prevailed in 2010. Lower vacancy trends have been noted at a time when absorption in square feet terms comes in close to two million on an annual basis. There has also been a shift to quality – at the end of 2011, the vacancy rate for Class AAA properties sat at just 0.2%. Calgary has created 44,000 net new jobs since January 2010, one of the best employment showings in Canada. The labour climate serves as a good indicator of office demand and helps explain why levels are robust.

If we look ahead, the value of non-residential permits remains below those heading into the recession. This suggests that there is still room for growth. In addition, in a survey from Statistics Canada, Alberta businesses plan to invest 12.2% more in non-residential construction in 2012 than they did in 2011. Industries tied to international trade stated the strongest intentions. At an industry level, mining, oil and gas sector investments will drive roughly one-fifth of all new investment activity this year. While the recent drop in crude oil prices is a concern, we expect prices to firm during the second half of 2012 – to about US$80-90 per barrel – and to rise towards US$100 per barrel in 2013. Natural gas prices will likely stay low, but creep up to US$3 per MMBtu over the next 18 months.

| CALGARY, ALBERTA<br>COMMERCIAL REAL ESTATE INDICATORS | 2010 | 2011 | 2012E |
|---|---|---|---|
| **Office Property Class** | | | |
| Vacancy Rate (%) | 11.8 | 8.1 | 7.0 |
| Downtown Class A Rent ( $ psf) | 28.6 | 31.0 | 32.3 |
| Suburb Class A Rent ( $ psf) | 19.9 | 20.3 | 22.0 |
| **Industrial Property Class** | | | |
| Availability Rate (%) | 4.9 | 3.1 | 3.0 |
| Rental Rate ( $ psf) | 7.7 | 8.2 | 8.2 |
| **Retail Sales (%)** | 5.6 | 6.7 | 7.2 |
| **Real GDP (%)** | 2.8 | 3.7 | 2.6 |
| **Unemployment Rate** (%) | 6.8 | 5.8 | 4.8 |
| **Employment (%)** | -1.2 | 2.9 | 3.9 |

psf: per square foot
E: Estimate by TD Economics as at June 2012.
Sources: CBRE, Conference Board of Canada, Haver Analytics.


CALGARY COMMERCIAL OFFICE MARKET

Source: Altus InSite. 2012 Estimate by TD Economics as of June 2012.

Helping to satiate some of the heightened demand are several large-scale, non-residential projects in the Calgary area. The Bow project (the tallest commercial building west of Toronto) is a good example – a north and south tower and retail space will add about 2 million square feet of rental space later this year. While much of the available space has already been absorbed by future tenants, the supply should help to slow the downward trend of vacancy. Submarkets in the mid-west and west are also benefiting from the squeeze in high-quality real estate in downtown areas. Suburb units remain a cheaper alternative ($32 per square foot downtown versus $22 in the suburbs) for Class A properties, but even these are increasingly harder to come by. It will be hard for supply to keep up with demand going forward given where the latter currently rests.

### Retail to benefit from income and wage gains

Retail sales in Alberta and Calgary are some of the best in the country. On a per capita basis, regional retail sales also come in well above the national average. Spending has been supported by high wage gains and disposable incomes. Our provincial economic forecasts have Alberta continuing to be among the top performers over the 2013-14 period; Calgary should be in the same relative position at the local level.

From a macro perspective, the natural resource outlook bodes reasonably well for retail sales demand. Still, Calgary is not immune to the headwinds plaguing the national picture. For example, the debt to income of an Albertan rests at just over 140%, the second highest score among the provinces. In addition, 8% of households have a debt service ratio above 40%. Given these metrics, residents will also need to curb their spending to some extent in order to repair their balance sheets. Plans for new supply will also help set the pace of the retail sector: the vacancy rate is sub-2%.

## EDMONTON – ENERGY-RELATED PROJECTS LIFT DEMAND IN THE CORE

Office demand in Edmonton has ramped up as the regional economy secured its footing after the recession. The unemployment rate currently sits at 4.4% (in June 2012), or 3.5 percentage points below its recession-high. For the year, the annual average jobless rate should be 4.9%. Investment intentions in the resource sector have been an important influence in firms wanting to snatch up real estate. We have seen strength in the office, commercial and retail sectors as well. Like Calgary, Edmonton should be among the top metropolitan economic and employment growth leaders which buoy office demand prospects.

The evolution of demand for office space since the recovery is seen in standard metrics like the asking rental rate. Just after the economy emerged from the recession, the market was flooded with inventory. Rents had to be lowered to deplete the excess supply either through back-fill tenancies or renovations. These pockets of vacancy are now absorbed and the property class is close to where it was heading into the recession – a remarkable turnaround in a short time.

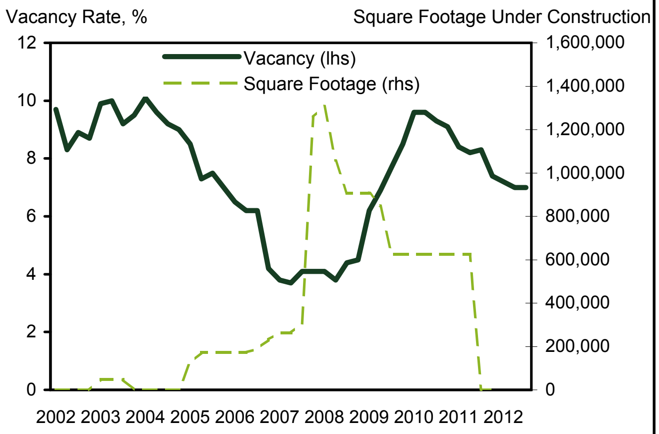
Heightened demand for office space persists across the downtown-suburb boundary line. Suburban office vacancy rates so far in 2012 are down nearly 50 basis points. There has also been a disproportional amount of net new demand in the downtown core. This is not easily seen through vacancy rate headline statistics, however, as it recently rose to 9.2%. However, the spike can be explained by the new $250 million EPCOR Tower added in the third quarter of 2011. Preliminary data suggest that the bulk of this new office supply has already been absorbed, meaning the vacancy rate has reverted back to below-9.0%.

Enbridge expansions were a main contributor to downtown office activity so far in 2012 – the absorption of this one company decreased the vacancy rate for regional Class A financial space by 2.45 percentage points. The near-term economic outlook points to the Edmonton market staying in tight territory – there is not enough new projects under construction to meet demand. In fact, as of the first quarter of 2012, no new office buildings were being built. Rents will move up as a result. Those looking to grab something at a cheaper price over the near-term may have to move down in quality or look for high-quality space in the suburbs.

| EDMONTON, ALBERTA<br>COMMERCIAL REAL ESTATE INDICATORS | 2010 | 2011 | 2012E |
|---|---|---|---|
| **Office Property Class** | | | |
| Vacancy Rate (%) | 9.3 | 8.5 | 7.2 |
| Downtown Class A Rent ( $ psf) | 21.5 | 20.6 | 23.2 |
| Suburb Class A Rent ( $ psf) | 16.8 | 16.9 | 16.5 |
| **Industrial Property Class** | | | |
| Availability Rate (%) | 6.1 | 4.2 | 4.0 |
| Rental Rate ( $ psf) | 8.6 | 8.9 | 9.0 |
| **Retail Sales (%)** | 6.4 | 7.8 | 7.5 |
| **Real GDP (%)** | 2.6 | 5.1 | 3.0 |
| **Unemployment Rate** (%) | 6.7 | 5.4 | 4.9 |
| **Employment (%)** | -0.7 | 5.9 | 2.3 |

psf: per square foot
E: Estimate by TD Economics as at June 2012.
Sources: CBRE, Conference Board of Canada, Haver Analytics.

EDMONTON COMMERCIAL OFFICE MARKET



Source: Altus InSite. 2012 Estimate by TD Economics as of June 2012.

### Oil and gas drive industrial space as well

Like the office segment, the oil and gas sector drives the industrial space. In particular, oil and gas service firms such as oilfield service providers are the ones who have been demanding property of late. We have seen demand outstrip supply and as a result, vacancy rates edged down from 6.1% to 4.2% towards the end of last year.

At the onset of 2012, anecdotal evidence seemed to indicate that developers were scoping out new projects to help bring supply to the market. This exploration may have softened a bit given the economic uncertainty abroad and the worries about a hard-landing scenario in China, Brazil and India. This latter case would negatively ripple through global commodity prices, an important economic indicator for business profits and confidence in the Edmonton area. Amid these lingering concerns, the price of West Texas Intermediate (WTI) has retreated from the high of US$106 in May to around US$85. According to our base case forecast, the price of oil should get back to the US$90-100 mark over the next year.

In the presence of general unease, demand for industrial real estate might wane in the second half of 2012, helping to ease some of the tightness present. This breather will not last long, as pent-up demand kicks in and new development projects are announced.

## OTTAWA – STABLE SO FAR, BUT AUSTERITY MINDSET TO PERSIST

In the run-up to the 2012 federal budget, there was concern that austerity would be put in place to restore fiscal order to the government's balance sheet. The payroll implications of expenditure restraint have already been felt in the region – public administration employment levels decreased in 2011, for the first time in five years. In the budget document ultimately tabled, we did get some details surrounding the austerity measures, including planned job cuts to the civil service and changes to the normal age of retirement for public sector employees. The government plans to eliminate about 12,000 positions over a three-year period. The tally shoots up to 19,200 when voluntary retirement provisions are taken into account. Roughly half of the job losses will take place in the National Capital Region. The provincial government also announced expenditure restraint policies in its 2012 budget. These austerity measures have important implications for the Ottawa-Gatineau economy, as nearly 20-25% of regional activity is derived from the public administration sector. Fiscal drag from cuts at the provincial and federal level should dampen the local economic profile.

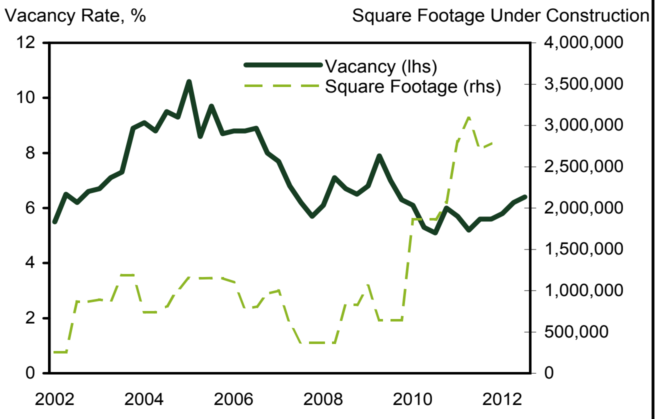
In the 2012 federal budget, there were no changes announced to how the federal government uses real estate. This is welcome news for the office market class, as the federal government helps provide some stability to both rents and vacancy rates, in contrast to some of the other urban centres which regularly record bigger swings. This is partly why the region did so well during the 2008-09 crisis. While job cuts will turn into lower office demand throughout our forecast period, pushing up the office vacancy rate above 6%, the government has not cut back on all new projects. For example, the department of Public Works and Government Services Canada has issued requests for temporary office space given renovations being done to other government-owned buildings. Export Development Canada moved into their new headquarters last year, but their vacated 400,000 square feet space seems to have been absorbed. Given higher vacancy rates and lower prevailing rates, the suburbs might benefit from firms leaving the downtown core. For example, Kanata has seen its market tighten over the past year with rents increasing.

OTTAWA-GATINEAU, ONTARIO/QUÉBEC COMMERCIAL REAL ESTATE INDICATORS

| | 2010 | 2011 | 2012E |
|---|---|---|---|
| **Office Property Class** | | | |
| Vacancy Rate (%) | 5.7 | 5.6 | 6.0 |
| Downtown Class A Rent ( $ psf) | 25.5 | 26.2 | 27.1 |
| Suburb Class A Rent ( $ psf) | 14.8 | 15.6 | 15.9 |
| **Industrial Property Class** | | | |
| Availability Rate (%) | 5.7 | 5.4 | 5.4 |
| Rental Rate ( $ psf) | 8.3 | 7.8 | 7.8 |
| **Retail Sales (%)** | 5.3 | 3.8 | 2.3 |
| **Real GDP (%)** | 2.6 | 1.5 | 1.8 |
| **Unemployment Rate** (%) | 6.5 | 5.6 | 5.4 |
| **Employment (%)** | 3.1 | 0.6 | 2.0 |

psf: per square foot
E: Estimate by TD Economics as at June 2012.
Sources: CBRE, Conference Board of Canada, Haver Analytics.

OTTAWA COMMERCIAL OFFICE MARKET



Source: Altus InSite. 2012 Estimate by TD Economics as of June 2012.

### Retail expansion amid the restraint

There are several new projects under development on the Ottawa retail scene. A mixed-use redevelopment project in Lansdowne Park is scheduled to finish in 2014-15 bringing sixteen hectares of new space which will be filled with shops, offices and residences. Cadillac Fairview Ltd. took complete control over the Rideau Centre, Ottawa's largest shopping complex, in late 2011. The new owners have indicated plans for an expansion and intent to pursue some U.S. retail chains. No timeline, however, for the expansion project was provided. Interest from foreign retailers could serve to increase rental rates as neighbouring locations become much more valuable and/or desirable, similar to what some locations are experiencing with Target's pending arrival.

While new projects are under construction, supply will be tepid given the regional economic climate. Austerity in some form or another is expected to persist until the government returns to surplus in fiscal year 2015-16. Job cuts and provincial civil servant wage freezes in the interim will keep people mindful about spending habits. As a consequence, we anticipate that growth in retail sales will come in at 2.3-3% this year, well below the pace recorded over the past 5-10 years. In addition to facing prospects for modest job and income growth, households will need to work on repairing their own balance sheets, given record levels of personal debt.

## TORONTO – ONSLAUGHT OF NEW OFFICE SUPPLY

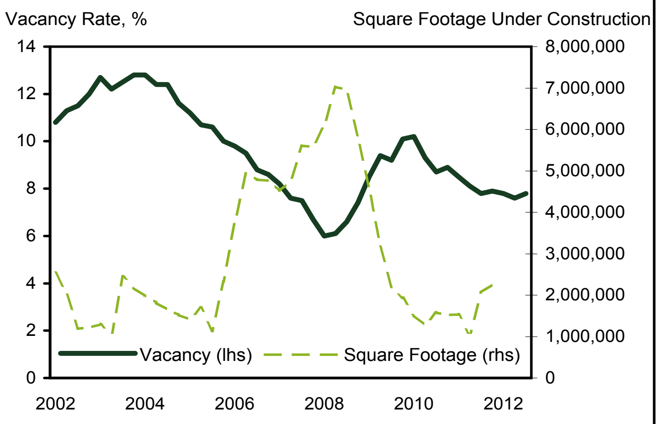
As part of its fiscal austerity efforts, the Ontario government plans to use its office space more efficiently. More specifically, it aims to reduce its real estate footprint by about one million square feet (equivalent to a 43-storey office tower) primarily in the Greater Toronto Area (GTA). Put another way, the government wants to decrease the space used per employee to 200 square feet versus the current 250 square feet. It will also seek out plans to divest ownership of buildings when and where it makes sense.

While no timelines were given for the government's real estate goals, the injection of new supply will help loosen an already tight GTA office segment. Recent demand for office space is currently high and available space has returned to near pre-recession levels. The availability rate is sitting below its decade-long average of 10%. There has also been a flight to high-quality, Class A units, but given the degree of current market tightness, the Class B and Class C vacated units are quickly being snatched up.

In the downtown core, there has been a noticeable pick-up in renovation and construction activity in the financial district. We saw a significant amount of development in the financial core shortly after the recession and it continues to support demand today. The number of condo projects under construction may also help explain the demand for downtown commercial space – developers and landlords are benefiting from the high-density living arrangements and the mixed-use commercial space that come along with condo development (e.g., retail space on the ground floor of the condo). It is important to note that heightened office demand is not just a downtown phenomenon – activity is being seen in the east/west and in the '905' area.

Office conditions should noticeably ease in 2013-14 as projects already under construction (RBC WaterPark Place and One York to name just a few) are completed. There are also several large projects rumoured to be in the works: a second tower for the Bay-Adelaide Centre or a new 180,000 square feet location for the CPP Investment Board. A recent article in the *Financial Post* estimated that Toronto could see up to 4.1 million square feet of new office commercial space over the medium-term. The number would jump to 5.1 million square feet if the government's injection of supply was taken into account.

TORONTO COMMERCIAL OFFICE MARKET



Source: Altus InSite. 2012 Estimate by TD Economics as of June 2012.

| TORONTO, ONTARIO<br>COMMERCIAL REAL ESTATE INDICATORS | 2010 | 2011 | 2012E |
|---|---|---|---|
| **Office Property Class** | | | |
| Vacancy Rate (%) | 9.6 | 8.3 | 7.8 |
| Downtown Class A Rent ( $ psf) | 24.4 | 24.2 | 25.0 |
| Suburb Class A Rent ( $ psf) | 16.5 | 16.3 | 16.5 |
| **Industrial Property Class** | | | |
| Availability Rate (%) | 6.6 | 5.5 | 5.5 |
| Rental Rate ( $ psf) | 4.7 | 4.7 | 4.9 |
| **Retail Sales (%)** | 6.4 | 4.7 | 3.2 |
| **Real GDP (%)** | 3.1 | 2.0 | 1.6 |
| **Unemployment Rate** (%) | 7.6 | 8.3 | 8.5 |
| **Employment (%)** | 2.3 | 1.4 | -0.5 |

psf: per square foot

E: Estimate by TD Economics as at June 2012.

Sources: CBRE, Conference Board of Canada, Haver Analytics.

Demand for office space might wane as well once the residential housing market undergoes a price correction over the next 2-3 years. In our view, the GTA is one of the urban centres which will encounter a greater-than-average residential price correction of around 15%. However, developments in the residential housing typically do not directly factor into commercial activity. Still, office demand will likely be muted indirectly given modest economic growth, slow income gains, and a gradual improvement in the jobless rate.

### Target eyeing the GTA

Target plans to open eleven of its first twenty-four stores in the GTA; its Canadian headquarters and distribution facilities will likely be set up in the region as well. The urban centre is a lucrative one due to its large population and fairly stable population growth. While the GTA's retail sales per capita do not match some of the western cities like Calgary, its residents spend more on retail per capita than the national average. Yet, the pace of GTA spending is likely to wane for several reasons: the perceived loss of wealth due to the residential market correction, uncertainty about the interest rate profile, and consumers becoming more focused on reducing their debt burdens. As a result, demand for retail space is likely to cool over the medium-term, putting some upward pressure on the retail vacancy rate.

## MONTRÉAL – INDUSTRIAL CLASS STARTS 2012 ON A POSITIVE NOTE

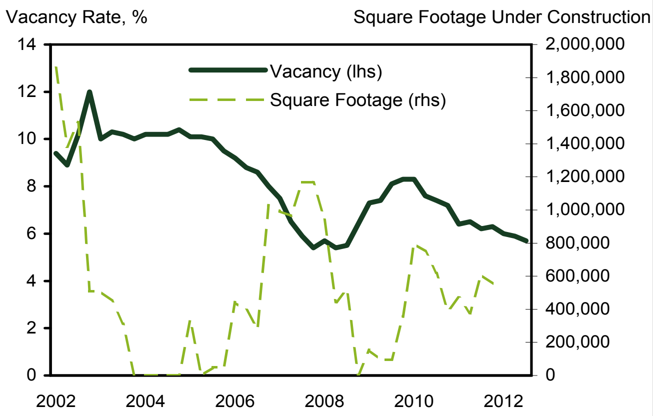
The office market in Montréal did extremely well in 2011: the region absorbed almost 900,000 square feet, making it the second year in a row it has approached the million mark. Strength and demand was seen in both downtown and the suburbs, with the former's vacancy rate falling from 8.1% in 2010 to 6.6% in 2011. Downtown rents and vacancy rates are now close to where they stood pre-crisis. Even with the solid hand-off, early data for 2012 suggest that the year has begun on a softer footing. Still, the vacancy rate has held steady and absorption so far this year is roughly 260,000 square feet due to a number of transactions in the suburbs.

With relatively tight conditions, it will be difficult to secure high-quality space. Few projects under works should make vacancy rates inch down to about 6% in 2012. It is unclear whether Montréal will undergo a new growth cycle to help loosen prevailing conditions. Supply could come through loft-type building conversions. Activity in these transformational-type projects is already being seen downtown. More traditional supply could also arise, but builders and developers may wait before making large-scale announcements given the current economic uncertainty. They might also opt to secure tenants and sign lease agreements well before the shovel hits the ground.

### A bright spot for the industrial sector

The industrial sector has struggled since the 2008-09 global crisis, in large part due to its out-sized exposure to manufacturing and looming economic headwinds like a high Canadian dollar and firm crude oil prices. Last year, the market was given a bit of a respite from these challenges, after seeing a positive net absorption of 2.7 million square feet. Year-to-date data suggest heightened activity has continued, with rents now close to $5.20 per square foot. There is also an interesting divergence between demand for small and large space: the market is tight for small spaces whereas it has been difficult to entice demand for large locations.

MONTRÉAL COMMERCIAL OFFICE MARKET



Source: Altus InSite. 2012 Estimate by TD Economics as of June 2012.

| MONTRÉAL, QUÉBEC<br>COMMERCIAL REAL ESTATE INDICATORS | | | |
|---|---|---|---|
| | 2010 | 2011 | 2012E |
| **Office Property Class** | | | |
| Vacancy Rate (%) | 7.9 | 6.6 | 6.0 |
| Downtown Class A Rent ( $ psf) | 20.6 | 22.0 | 22.3 |
| Suburb Class A Rent ( $ psf) | 14.5 | 14.5 | 14.6 |
| **Industrial Property Class** | | | |
| Availability Rate (%) | 10.3 | 9.6 | 9.5 |
| Rental Rate ( $ psf) | 5.0 | 5.1 | 5.2 |
| **Retail Sales (%)** | 6.4 | 0.6 | 2.2 |
| **Real GDP (%)** | 3.2 | 1.8 | 1.1 |
| **Unemployment Rate** (%) | 8.6 | 8.3 | 9.4 |
| **Employment (%)** | 2.6 | -0.1 | -1.0 |

psf: per square foot
E: Estimate by TD Economics as at June 2012.
Sources: CBRE, Conference Board of Canada, Haver Analytics.

While the recent numbers seem to lift spirits for an industrial sector recovery in the region, we expect both rents and vacancy rates to tread water for the rest of the year and into 2013. This is because local economic conditions, both in terms of economic growth and employment, will be modest. Second, firms who are looking for external volatility to subside may have to wait a while given the re-intensification of economic risks. Third, industrial vacancy rates and rents have been quite steady in recent years, a trend we expect to persist. Fourth, the Montréal region is close to the U.S., both geographically and economically, and our base case forecast has our neighbour chugging along at 2-2.4% growth over 2012-13.

The outlook for the industrial class cannot be calculated solely on domestic and international economic developments. This is because the industrial real estate sector in Montréal has started to diversify itself in recent years. Granted, it still remains manufacturing-heavy, but a good example of a growing category is the distribution and logistics sector. This segment is situated mostly outside downtown. The suburb location also helps firms avoid the road congestion problems of getting downtown. The completion of the A30 highway bypass on the South Shore should help firms improve shipping capabilities, increasing the overall desirability of the area. What's more, employees could also have an easier time getting to their place of work. Initial timelines released by the Québec government have the road project complete by no later than December 2012. Heightened demand for high-quality space could mean localized rent rate increases and a decrease in overall availability.

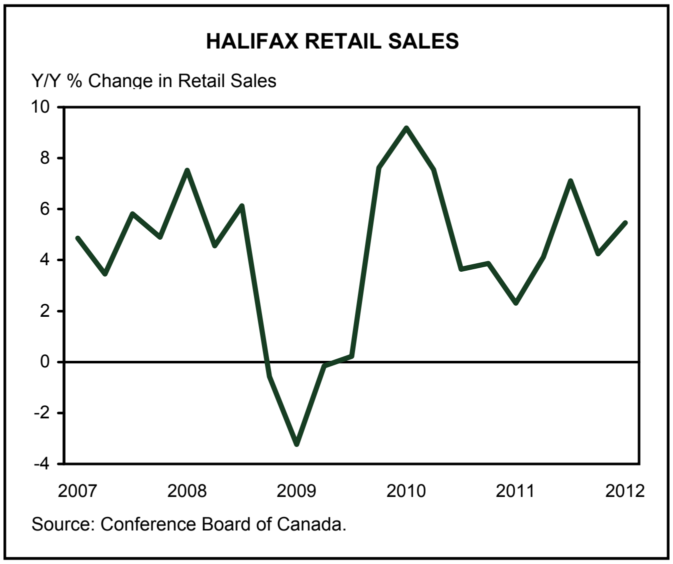
## HALIFAX – EASING A BIT BEFORE SHIPBUILDING GETS UNDERWAY

Over the past few years, the Halifax economy has received a huge boost from its manufacturing sector, thanks in part to: the construction of new facilities to produce and process natural gas from the Deep Panuke field and large scale projects to build fleet for the Canadian Coast Guard and restore navy frigates. This increased activity has helped boost manufacturing output since the early part of the recovery, and the industrial class in Halifax has reaped many of the benefits. New supply (approximately 205,000 square feet in 2011) helped keep a lid on rental rate growth – rents per square foot are currently running $7.50, or close to where they have been over the last few years.

The industrial segment will be given the chance to rest a bit as many of the projects have wrapped up or their economic impacts have waned since construction first began. At the same time, the Halifax economy is beginning to prep for the $25 billion shipbuilding contract awarded to Irving Shipbuilding in late-2011. Demand for high quality real estate space due to the contract is expected to spill over to all property classes, but will be felt acutely in the industrial class. Preliminary estimates for 2012 suggest that 100,000 square feet of new industrial space will be brought to market. Yet, this amounts to much less than what was delivered in 2011. Given the underlying economic conditions and preparatory work just beginning in earnest for the new contract, we expect industrial activity to be fairly tight for the second half of the year and the early part of 2013. Rents should increase and availability rates ought to edge down to 5.6%, before new supply alleviates some of the pressure.

### Office demand creeps up in the suburbs

The suburb class made tremendous strides in 2011. This is nicely demonstrated by low vacancy rates (7.4%) and Class A rental rates of just over $16 per square foot. However, the lure of suburbia came at the expense of the central business district and the downtown core – the vacancy rate in the latter moved up from 9.9% in 2010 to 10.4% in 2011. Preliminary data suggest that this downtown-suburb divide has continued so far in 2012 and we expect the trend to persist in the second half of the year.


HALIFAX RETAIL SALES

Source: Conference Board of Canada.

| HALIFAX, NOVA SCOTIA<br>COMMERCIAL REAL ESTATE INDICATORS | 2010 | 2011 | 2012E |
|---|---|---|---|
| **Office Property Class** | | | |
| Vacancy Rate (%) | 9.1 | 8.6 | 8.4 |
| Downtown Class A Rent ( $ psf) | 18.4 | 18.1 | 18.3 |
| Suburb Class A Rent ( $ psf) | 16.1 | 16.2 | 16.3 |
| **Industrial Property Class** | | | |
| Availability Rate (%) | 4.7 | 5.9 | 5.8 |
| Rental Rate ( $ psf) | 7.2 | 7.4 | 7.5 |
| **Retail Sales (%)** | 6.0 | 4.4 | 3.4 |
| **Real GDP (%)** | 2.5 | 0.5 | 1.9 |
| **Unemployment Rate** (%) | 6.3 | 6.0 | 5.5 |
| **Employment (%)** | 0.9 | 1.3 | 2.0 |

psf: per square foot

E: Estimate by TD Economics as at June 2012.

Sources: CBRE, Conference Board of Canada, Haver Analytics.

Looking ahead to 2013-14, demand for suburb space ought to hold steady given the economic climate. However, the geographical differences being seen in the Greater Halifax office class will wane over this period. First, downtown landlords and developers will probably have to lower their asking price on units, in order to compete with the cheaper-priced suburban units. This could translate into lower rents among all quality grades, but given demand conditions, we suspect that rents might dip in Class B and C only. There are also several large office projects set for completion over the near-term such as Nova Centre or the Waterside Centre. This new supply ought to spur upward pressure on vacancy rates.

### Renovations in retail

Retail vacancy rates fell sharply in the second half of 2011, landing at 6.8%. This was somewhat of a surprise given the roughly 450,000 square feet of new supply. Absorption rates trumped the new supply, however, coming in at 635,000 square feet, or roughly three times the recent average. We do not anticipate much more of a plunge in 2012 given that the retail market is moving from construction towards renovation and transformation of existing units. A case in point, several malls in Halifax have recently undertaken renovation projects.

## References

1. Annual commercial real estate transaction volume was provided by Avison Young.

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