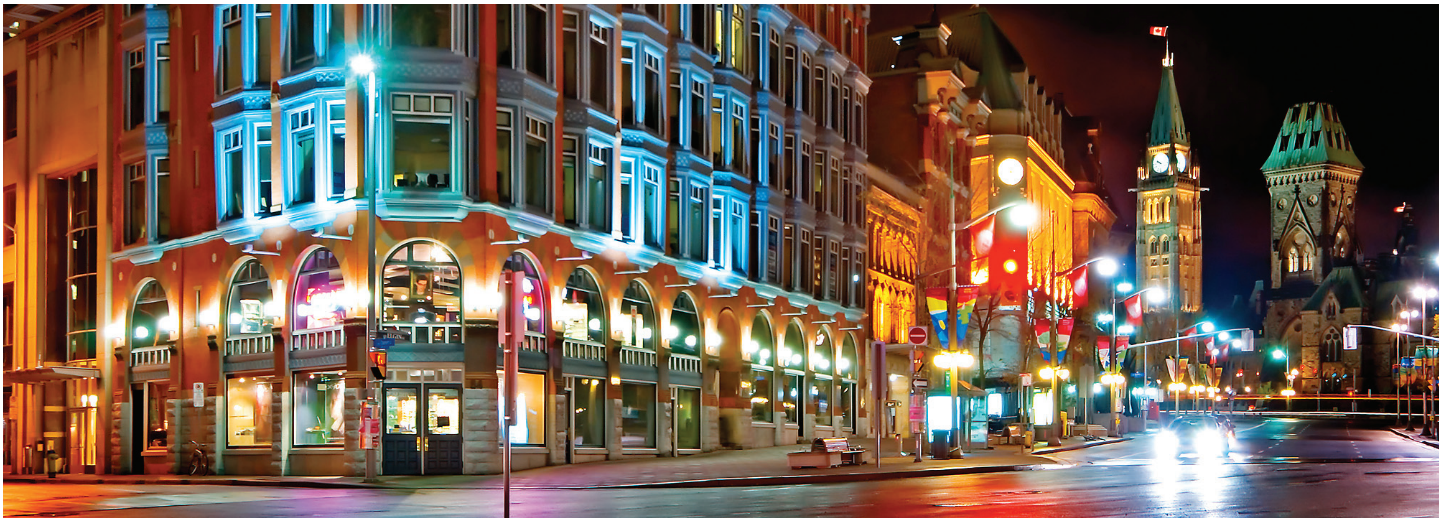
Canada's Real Estate Markets

Sheila Botting, FRICS, looks into why the Canadian economy and commercial real estate market are proving more durable during the global financial crisis.



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Global economies abound with dismal but improving news — high unemployment, low GDP, weakened consumer spending, reduced demand albeit improving, unbelievable debt, significant stimulus monies, restrictions on capital and for real estate, few if any transactions. Canadian real estate delayed its entry into true recessionary conditions but fell early in 2009. That said, compared with other countries, Canadian vacancies remain reasonable, rents although softer are solid and bankruptcies and mortgage defaults remain nominal. New office buildings with green features are leasing at solid rates. Analysts continue to be amazed at the durability of Canadian markets during this recession.

Across investment and leasing markets, participants have delayed major decisions, instead opting to "wait for the bottom" and remain on the sidelines. Well capitalized vendors are holding on for better times, while prospective purchasers await deal-making opportunities. In a rising market, "market proof" is required to corroborate ascension to a higher plateau. A declining market requires an intuitive approach by investors. Canadians are conservative by nature and prefer to wait rather than rush toward decisions. Recent economic signals show GDP will bottom at -2.9 percent for 2009 and economists forecast 2010 GDP in the 2.6 percent range commensurate with U.S. indicators (Figure 1).

Several factors contribute to Canada's resilience including stable and conservative financial institutions and lending practices, a diverse economy, competitive investment returns and real estate markets based on solid fundamentals. Once the economy rebounds, a strong foundation exists for a stable real estate future in Canada's commercial markets.

World Economic Forum Claims Canada has Soundest Financial System in the World

Canada's leading position through the economic downturn can be attributed to the strength and stability of its banking system. With banks worldwide — particularly in the United States — experiencing record losses, closures, and government support, Canadian banks have posted profits in recent quarters. A year ago, the World Economic Forum dubbed Canada as having the soundest financial system in the world.

More recently, Canada's four largest banks increased their ranking among North American financial institutions to become the 7th to 10th largest banks as measured by assets. Led by the Royal Bank of Canada (RBC), which has tripled assets during the past decade, TD Canada Trust, Scotiabank, and Bank of Montreal (BMO) remain the top performing Canadian banks.

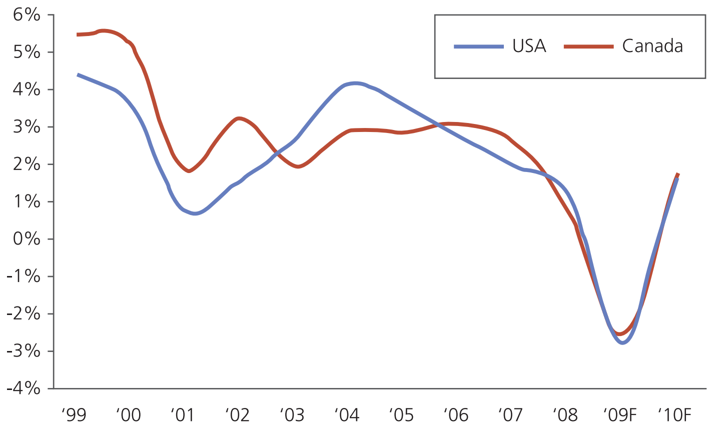

Figure 1: Markets Decline—US & Canadian Recession (GDP)
BMO Nesbitt Economic Research

Some of the disparities in performance between U.S. and Canadian banks can be attributed to the fundamental differences in the banking systems. Canada tends to have more restrictive lending and capital boundaries, a concentrated number of institutions, nationwide branching, and less leveraged capital. These fundamentals allow Canadian institutions to respond and diversify nationwide. Geographic diversification also acts as a method of mitigating investment risk, which is especially important when balancing the resource and tourism sectors in the west with manufacturing and financial services in central Canada.

Nationally Diverse Real Estate Markets

Canada is geographically the second largest country in the world with almost 10 million kilometers squared (or 3.85 million square miles), with the longest coastline and longest border with another country, the United States. Yet Canadian urban centers and indeed its real estate markets stretch along the Canadian/U.S. border and combined are only the size of New York City's markets. Canada's major markets are shown in Figure 2.

Canadian Industrial Markets

Industrial real estate is the largest asset class with some 1.5 billion square feet across the major markets. The Greater Toronto market is the third largest market in North America (behind only Chicago and Los Angeles) and holds approximately half of Canada's industrial space. Toronto is the manufacturing backbone of Canada and is dominated by the automotive industry, producing roughly one in six North American automobiles. Toronto also serves as the regional and national inland distribution hub. Other large industrial hubs include the Port of Vancouver and inland Calgary hubs for western Canada along with Montreal and Halifax in the east.

Canada's industrial markets provide portfolio stability due to their mature and diverse nature. Figure 3 shows that industrial vacancies have consistently remained in the 4 to 7 percent range, consistently below U.S. markets since 2000 as new supply has been balanced by market demand. Contributing reasons for the historically strong and stable performance of industrial real estate investment include:

- broad-based user/occupancy structure;
- relatively low cost of re-tenanting and retrofitting space;
- and positive long-term industrial market leasing performance and prevailing low vacancy rates.

Canadian Office Markets

Canada's office markets total approximately 414 million square feet of space. Again, Toronto is the most significant Canadian market with 163 million square feet, comprising the fifth largest market in North America. Toronto is the financial capital of Canada and dominated by banks and financial institutions along with their service providers including legal, accounting and other professional services, as well as being home the nation's primary stock exchange. Government and health care are also significant space users.

	Office		Industrial	
	Inventory (sf)	Vacancy Rate	Inventory (sf)	Vacancy Rate
Vancouver	46,453,294	6.9%	181,087,548	4.2%
Calgary	52,960,967	10.2%	103,282,241	5.3%
Edmonton	23,879,721	6.9%	95,051,577	2.5%
Toronto	162,830,064	6.6%	834,970,979	7.1%
Ottawa	36,171,011	6.5%	22,364,490	4.4%
Montreal	82,446,396	8.9%	277,144,076	8.2%
Halifax	9,411,007	9.3%	6,465,783	8.7%
Major Market Summary	414,152,460	7.6%	1,519,432,804	6.5%

Figure 2: Canada's major real estate markets

Cushman & Wakefield (August 2009)

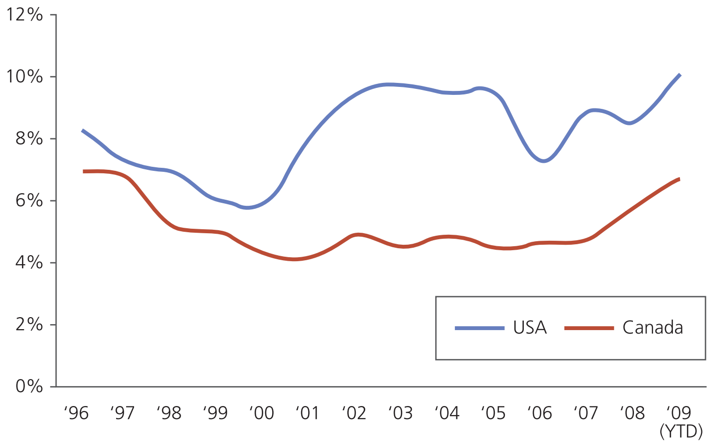

Figure 3: Industrial Vacancy Rate
Cushman & Wakefield (Q2 2009)

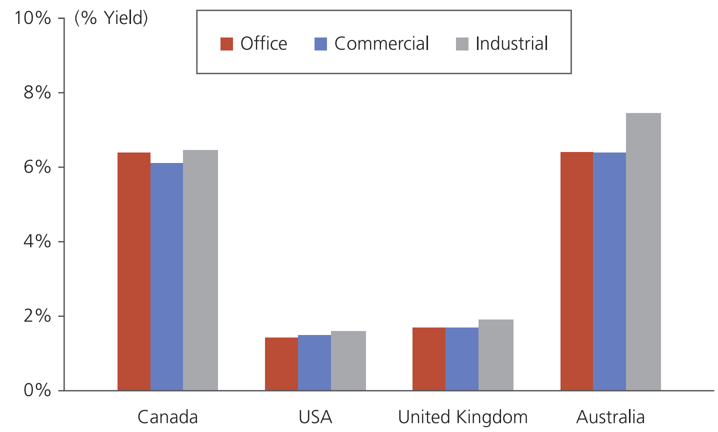

Figure 4: International Investment Yields
IPD Multinational Index

Montreal, Calgary, Vancouver, and Ottawa (the nation's capital) are other large Canadian office markets, each with unique occupancy characteristics and demand drivers.

During the peak of 2005 and 2006, unprecedented low vacancy rates, high levels of demand and rising rental rates spurred new construction across Canada. As a result, there is a considerable new development underway in Downtown Calgary (more than 8 million square feet) and Downtown Toronto (more than 3 million square feet), most of which will be completed between the second half of 2009 and year-end 2011. While traditionally tight office markets have softened, the new supply anticipated during the next several years will undoubtedly place downward pressure on achievable rents as landlords seek to retain tenants in the face of rising vacancy. In Toronto, a range of tenants are moving from older downtown towers to the newer "green towers" that offer competitive operating costs and sustainable environments.

Globally Competitive Investment Returns

Canadian investment returns have remained competitive globally and have therefore attracted numerous international investors seeking solid risk-adjusted returns. Similar to global trends, Canadian real estate has faced increasing capitalization rates and decreasing values during the last year, as well as a sharp decline in transaction activity. That said, Canada tends to have a disciplined and stable real estate investment environment compared with international markets. This stability is in part due to a high concentration of ownership among pension funds and major investors that is particularly focused on downtown office and major retail assets. Furthermore, Canada's lending and new development practices have limited new supply to largely reflect demand within most markets.

Total annual real estate returns during 2005 and 2006 reached highs in the 17 percent to 21 percent range as owners enjoyed considerable capital appreciation. This range dropped significantly to just 1 percent to 7 percent in 2008. As of June 2009, all asset types continued to experience year-over-year declining rates of return due largely to an erosion in value.

Given the above, a key investment strategy among many institutional players has seen a shift from income-producing assets during the peak years of 2005-06 to buying debt. Long-term investors continue to seek low-risk investments to balance their portfolios. Prospective vendors have only recently begun to acknowledge the new reality of higher capitalization rates. As well, financing for real estate has diminished substantially. As a result, investment volumes are down significantly from those seen pre-2008, and, overall, deals are taking longer to consummate. Prevailing purchaser sentiment suggests that capital is once again looking to commercial real estate markets for investment opportunities.

Across investment and leasing markets, participants are delaying major decisions, instead opting to be patient and wait to take advantage of opportunities. As a result, Canadian markets are well positioned for acquisition opportunities based on sound fundamentals, along with an opportunity for value improvements when markets rebound.

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