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# British Columbia Real Estate Investment Review

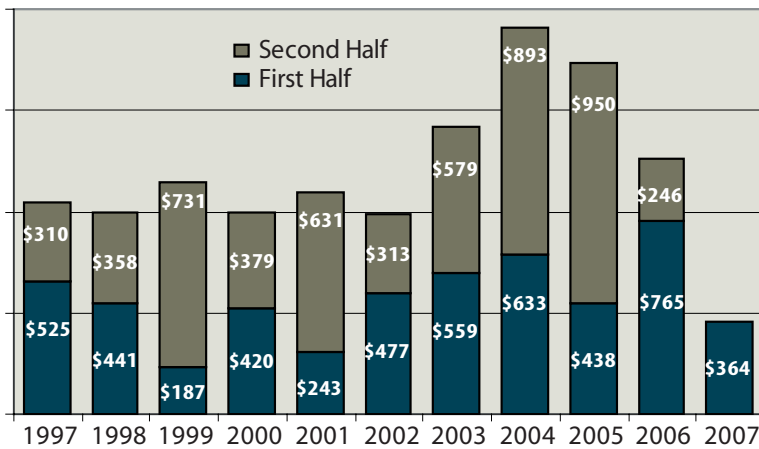
First Half 2007



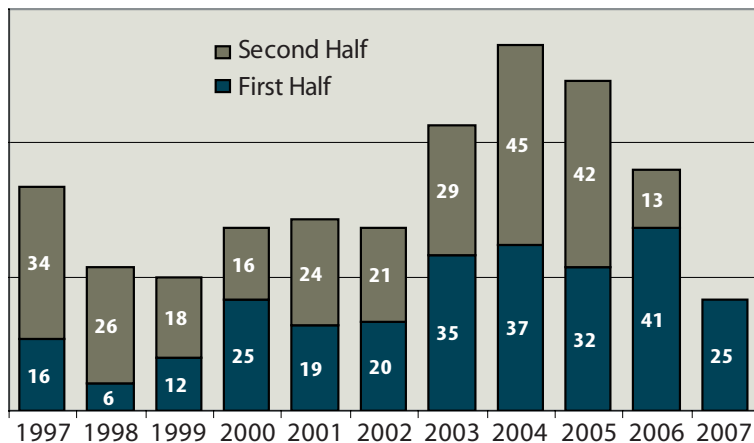
## First Half 2007

Total value (sales > \$5 million):	<b>\$364.2 Million</b>
Total number of transactions:	<b>25</b>
Most active buyers:	<b>Private</b>
Most active sellers:	<b>Private</b>
Most active asset class:	<b>Office</b>

BC Investment Sales by Dollar Volume  
(Properties >\$5 Million)



BC Investment Sales by No. of Transactions  
(Properties >\$5 Million)



## Market Summary

Activity in the real estate investment markets of British Columbia has fallen, both in terms of dollar volume and the number of transactions, to levels not seen for five years.

This lessened market activity is against a backdrop of strong economic fundamentals. The Province is showing population and employment gains and the annual inflation rate is within an acceptable range, at 2.2%.

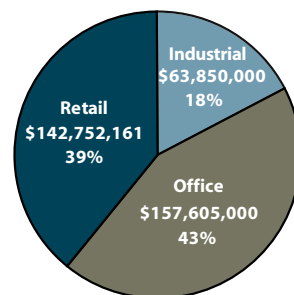
However, there are economic issues, particularly currency and interest rate movements, which if sustained, will slow the regional economy.

Since the beginning of 2007, the Canadian Dollar has appreciated by 10.5% against the US Dollar to stand at \$0.95. Exporters are feeling the affect of the currency appreciation. The Province's lumber industry, already hit by a slumping US housing market and sub-prime mortgage foreclosures, has received a further set-back through the appreciation in the value of the Canadian dollar.

The Bank Rate, steady since the beginning of the year, stands at 4.25% but is expected to increase by 25 basis points at the next Bank of Canada setting in July. To the extent that the Bank Rate is the benchmark for various money market rates, any increase will have a negative impact on the general economy and, by extension, real estate markets.

More importantly for real estate investors, bond yields have increased steadily since the end of 2006. The Government of Canada benchmark 10 year bond yield stands at 4.6%, up from 3.9% at the end of the year.

Sales by Property Type  
First Half 2007

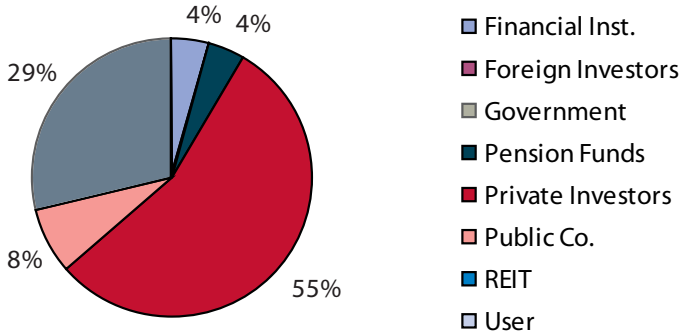


## Buyer Profile

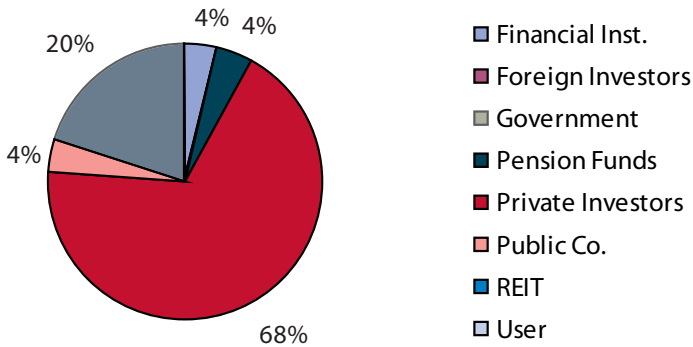
The last six months, like the preceding twelve months, have been relatively quiet as far as trades are concerned. Once again, private investors have been dominant on the buy side of the market accounting for 55% of the dollar volume and 68% of the transactions recorded in this period's report. The institutions are largely absent from the market.

The second most active group were REITs. They accounted for 29% of the dollar volume and 20% of the reported transactions.

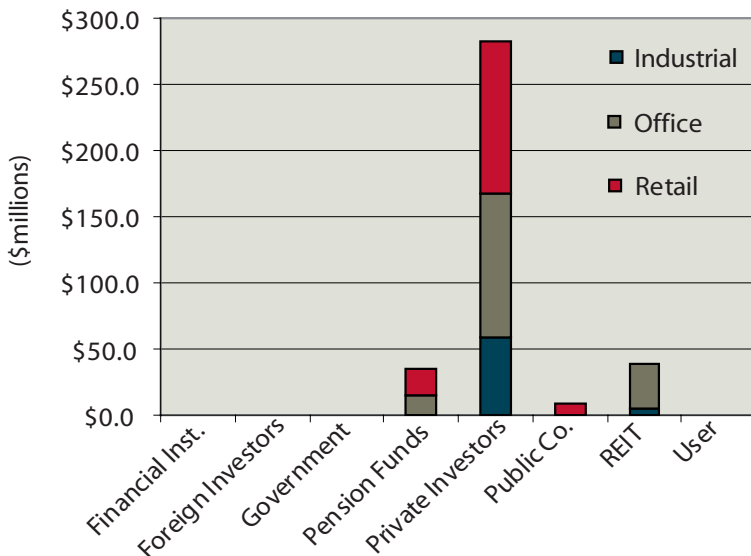
First Half 2007: Value of Purchases by Type of Buyer



First Half 2007: Number of Transactions by Type of Buyer



First Half 2007: Purchases by Asset Type

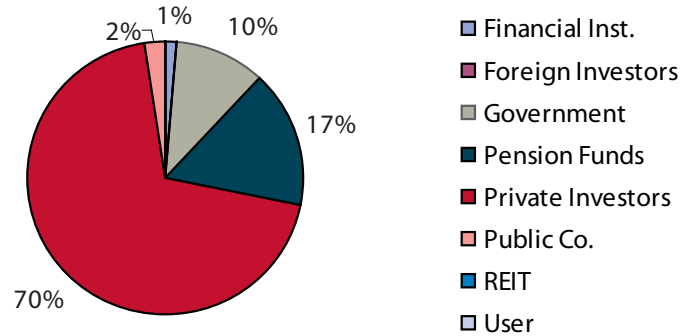


## Seller Profile

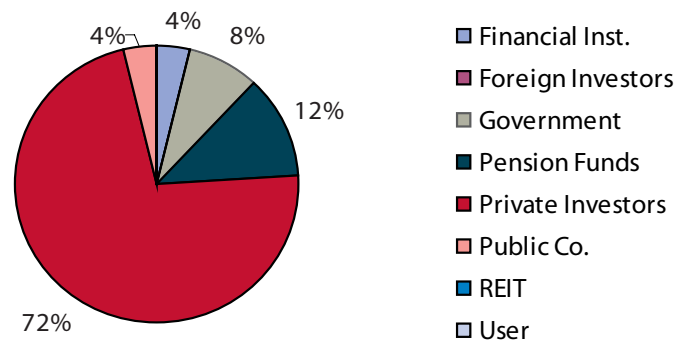
Similar to the pattern of the last year, private investors are the single largest class of investors selling properties in the last six months. This group accounted for 70% of the dollar volume and 72% of the trades recorded in this report.

Pension funds were the second most active class of sellers during the last six months, accounting for 17% of the dollar volume and 12% of the sales.

First Half 2007: Value of Sales by Type of Seller



First Half 2007: Number of Transactions by Type of Seller



## Overall Activity

The market for investment real estate in British Columbia remains strong. However, there is a gap between what sellers expect to receive and what investors are willing to pay. As a result there have been relatively few trades in the last six months.

With a continuing upward movement in long bond yields, investors will find it increasingly difficult to justify paying the prices that have been witnessed in British Columbia for the last several years.

If net income does not increase, then in order to maintain investor yield, prices will need to decrease. We would expect to see more market activity as investors harvest accrued gains ahead of any fall in values.

## International Investment - The Drive to Portfolio Diversification

Ten years ago, Ireland was one of Europe's proverbial church mice. Not only did the country have a serious emigration issue but it was also unable to attract badly needed direct investment into the country.

How times have changed. The Celtic Tiger roared and reversed the trends of ten years ago, aided and abetted by shrewd tax policies devised by a Euro-centric Irish government.

Corporate tax rates were cut to 12.5%, the Irish welcomed the Euro and stood in line to accept the largesse of the European Union. Infrastructure development financed by the EU opened up the country to development.

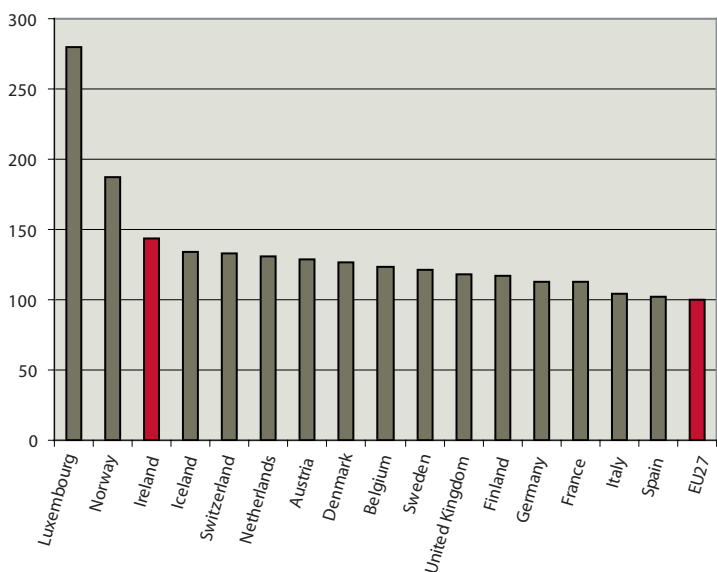
field with 30% of their assets in Europe, 33% in the US and the balance in Canada. The fund recently invested in Russia through a diversified international real estate fund with strength in Moscow and St. Petersburg. The Asian markets of Shanghai and Beijing are under analysis.

BCimc, with 11.3% of its total assets invested in real estate, has sought real estate investments in the United States, Mexico, Europe and Asia. Other funds, including OMERS, with 10.3% of its net assets in real estate, are developing global real estate investment platforms.

Canada is a market that is simply too small for many investors, where prudence dictates that they diversify their real estate portfolios. Canada isn't alone. Fund managers around the world are exploring investment opportunities beyond their domestic boundaries.

The International Property Databank publishes excellent comparative data on property returns in a variety of markets - see the following chart.

Index of GDP per inhabitant in 2006 in PPS<sup>1</sup> (>100) Eu = 100



Source: Eurostat  
<sup>1</sup>Purchasing Power Standard.

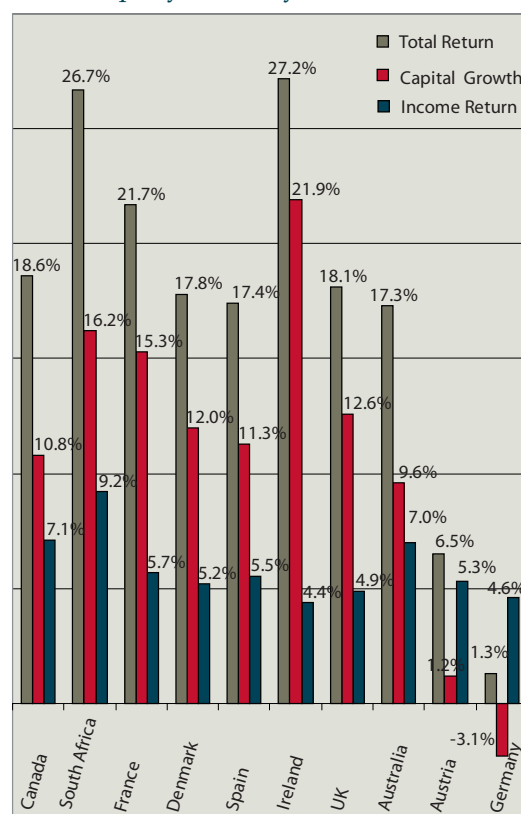
Wealth generated by the economic boom is now being re-cycled into a variety of investments. The Irish have always enjoyed a love affair with property and this sector has acted as a magnet for Irish investors of all types from pension funds to individuals.

Ireland, with a relatively small population, has limited capacity for commercial investment. Prudent real estate investors in efforts to spread risk are looking beyond domestic boundaries. It is therefore not unusual for Irish fund managers to feel as comfortable discussing the relative risks of real estate in Chicago, Boston, Prague, Dubai or Sophia as they do when discussing Dublin.

The point of this commentary, which could just as easily have been about any number of countries, is to illustrate the types of dynamics at play as international investors continue to seek opportunities which will meet their investment goals, whilst balancing risk. Going "off-shore" is now considered a mainstream real estate investment strategy.

Canadian investors are enjoying the benefits of off-shore real estate investment. Pension funds are leading the charge. The Caisse de Dépôt and its real estate subsidiary, SITQ, have been a leader in the

2006 Property Yields by Selected Countries



Source: Avison Young, Investment Property Databank and Irish Society of Chartered Surveyors

A growing transparency coupled with international accounting standards, international valuation standards, currency hedging techniques, advanced technology and communications is allowing international real estate markets to flourish. Investors are becoming increasingly comfortable with cross-border transactions.

In summary, we expect Canadian investors to remain bullish on off-shore real estate investments. Such investment strategies will allow investors to diversify risk and, hopefully, enhance returns.



A recent City of Vancouver planning report recommends an increase in the allowable density in the Vancouver CBD.

### Commentary

The fundamentals of the British Columbia office market are extremely strong. The B.C. economy is growing at a healthy rate and with it there is an expansion in the demand for office space. Because of a lack of office space, particularly in the Lower Mainland's urban markets, there is a significant pent-up demand for new space.

The Province's major office market is concentrated in the Lower Mainland with about 44% of that space located in the Downtown sub-market.

The Lower Mainland market is tight with a 5.1% vacancy. The Downtown market is at 2.5%, or 480,000 s.f., of which 39% is in Class AAA and A buildings.

There are no significant office buildings under construction in Down-

town Vancouver and none likely to come on stream until 2011, at the earliest. Bentall recently announced an intention to build 400,000 s.f. at Thurlow and Alberni.

With a growing pent-up demand and lack of new supply, rents have only one direction in which to move. The market is now witnessing net rents pushing through the \$40 per s.f. ceiling. In order for new development to come on stream, sustainable rents at this level, or greater, will be required for profitable development.

Apart from the Birk's Building sale earlier this year there have been no sales in the Downtown core. We have yet to see any upward movement in capitalization rates, notwithstanding the recent increase in long bond yields. It may just be a matter of time. Current office yields in the Vancouver core are in the 6% range.

Property	Price	Vendor Type	Buyer Type	Date
Birks Building, Vancouver	\$22,885,000	Pension Fund	Private	January 2007
4400 Dominion, Burnaby	\$18,300,000	Pension Fund	REIT	June 2007
Royal Bank Building, New Westminster	\$17,250,000	Private	Private	March 2007
Royal Bank Building, Broadway	\$15,600,000	Private	Pension Fund	January 2007
Van Tech Centre II, Vancouver	\$15,500,000	Private	Private	January 2007
3665 Kingsway, Vancouver	\$14,575,000	Private	Private	June 2007
Queen's Court, New Westminster	\$14,500,000	Private	REIT	January 2007
Hycroft Centre, Vancouver	\$12,775,000	Private	Private	March 2007
353 Water Street, Vancouver	\$7,890,000	Private	Private	March 2007
Datatech Building, Victoria	\$7,210,000	Private	Private	May 2007
3680 East Hastings, Vancouver	\$6,120,000	Private	Private	March 2007
1638 East Broadway, Vancouver	\$5,000,000	Private	Private	January 2007
<b>TOTAL</b>	<b>\$157,605,000</b>			

## Commentary

The looming question with respect to investment retail property is "When will the heady days end?"

In the first half of 2007 most retailers were anticipating a softening of the market but cost escalations have resulted in developers continuing to reach for higher rents and, to date, retailers have still been willing to pay, despite reaching their economic limits.

If there is a slowdown in the consumer market, similar to that in the U.S., the ability to pay higher rents will diminish and despite rising costs and lack of supply, the market will slow down. Projects that hinge on higher rents to justify starting construction may not be developed.

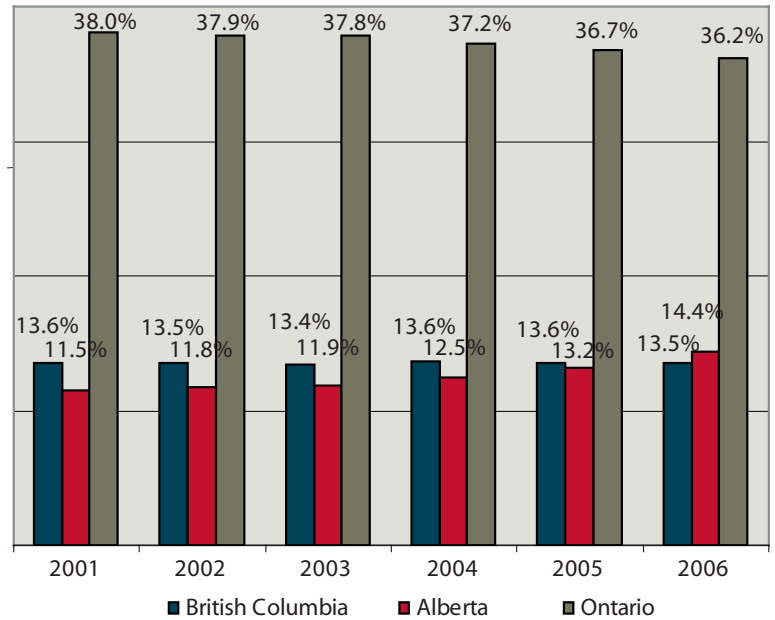
With the narrowed margins there could also be purchaser "fall-out" with land acquisition deals collapsing.

Adding to the fuel is the rising cost of debt and the higher Canadian dollar, which is slowing tourism and encouraging Canadians to shop outside of Canada. Higher interest rates are also reducing investor yields and could result in a softening of capitalization rates.

Notwithstanding global and local issues and the potential for an economic slow down in the second half of 2007, retailers will still want to be in the B.C. market. The lack of supply will help maintain the existing rental rates. However, the market should flatten-out and new projects, that are hinged on even higher rates, will either adjust downwards to current rates, or perhaps not proceed.

Capitalization rates are in the 5-6% range for prime retail properties.

Percentage Share of National Retail Sales: 2001 - 2006



Source: Statistics Canada



The Steveston Marine Building is a recent offering.

Property	Price	Vendor Type	Buyer Type	Date
Landsdown Mall, Kamloops	\$48,000,000	Private	REIT	June 2007
Clover Square Village, Surrey	\$28,500,000	Private	Public	March 2007
Westbank Shopping Centre, Westbank	\$19,000,000	Pension Fund	REIT	June 2007
Rona, Abbotsford	\$16,250,000	Private	Financial Institution	April 2007
Cactus Club, Vancouver	\$12,100,000	Private	Private	February 2007
104th & 105th Avenue, Surrey	\$9,900,000	Private	Private	January 2007
2525 160th Street, Surrey	\$9,002,161	Public	Private	February 2007
<b>TOTAL</b>	<b>\$142,752,161</b>			



The thriving industrial park on Annacis Island in the Fraser River.

## Commentary

The fundamentals of the British Columbia economy are sound. The economy is operating in high gear and the prospects for continued growth are excellent.

With 13% of the Canadian population, B.C. is Canada's third largest province, after Ontario and Quebec. B.C. produces 12% of the country's GDP.

B.C.'s economy is less resource driven than it used to be. It's also increasingly less dependent on producing goods, rather than services, as a source of employment and GDP.

The provincial manufacturing industry is the largest in the goods producing sector with 60% of all manufacturing jobs located in the Lower Mainland. The warehouse and transportation industry is largely centered in Vancouver, the hub of the Province's transportation system.

The economic boom in the Province has been augmented by a large number of major capital projects planned, or underway. In March, 800 projects were in the Provincial capital projects inventory at an estimated cost of \$124 billion, an increase of 37% over the previous year. Approximately 50% of those projects are located in the Lower Mainland and roughly half of those projects are in the residential and commercial construction sectors

The British Columbia industrial investment market continues to attract strong investor attention. Like all other sectors, however, there is a shortage of investment properties, as evidenced by the handful of sale transactions which occurred in the last six months.

Land prices continue to escalate. Industrial land in the urban areas of the Lower Mainland is selling for more than \$1 million an acre due largely to a physical constraint on the supply of zoned and serviced sites.

Construction costs are increasing for both material and labour. There is intense competition for skilled labour, both in British Columbia and Alberta. The result is increased product cost, which coupled with high land prices leads to higher rents.

We have yet to see any effect in the industrial market of recent interest rate increases, or Canadian currency appreciation, which if sustained, will affect exports from the Province.

Capitalization rates for industrial operations have stabilized in the 6% - 7% range.

Overall, we expect to see sustained and largely unsatisfied demand for industrial investment product for the foreseeable future.

Property	Price	Vendor Type	Buyer Type	Date
2400 Boundary Road, Burnaby	\$28,100,000	Government	Private	May 2007
9300 Van Horne Way, Richmond	\$10,000,000	Government	Private	January 2007
2000 Brigantine Drive, Coquitlam	\$9,600,000	Private	Private	January 2007
4693 / 4771 Vanguard Street, Richmond	\$5,700,000	Private	Private	May 2007
1781 West 75th Street, Vancouver	\$5,400,000	Private	REIT	May 2007
3133 Sumner Avenue, Burnaby	\$5,050,000	Financial Institution	Private	March 2007
<b>TOTAL</b>	<b>\$63,850,000</b>			

## The Investment Market: If the Tide Recedes

Canadian commercial real estate markets have been on an upward trend for the last several years. Is that trend about to reverse?

What happens when prices fall and capitalization rates increase?

For the past several years we have experienced so called “cap rate compression”, whereby increasing values, in the absence of income gains, have resulted in a decline in capitalization rates.

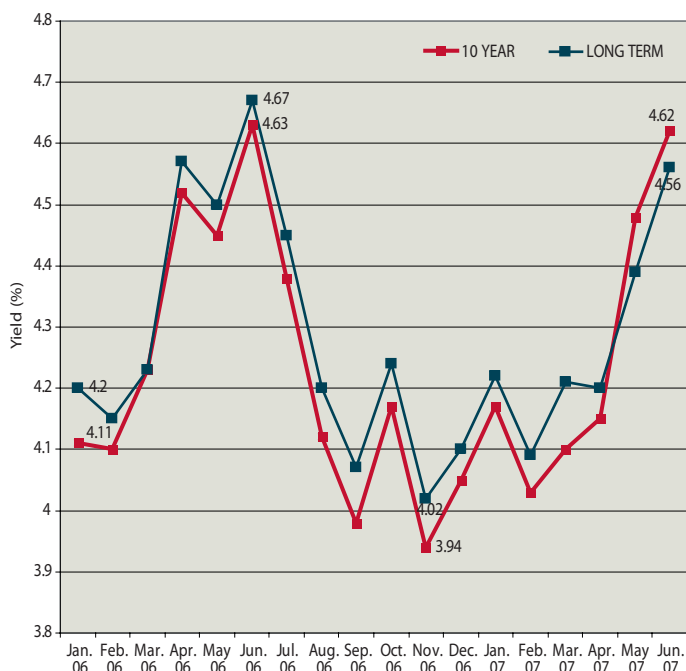
In periods when too much money is chasing too few goods, the result is price inflation. In the global real estate markets it is acknowledged that the world is awash with capital looking for a home. Property markets have been very accommodating.

Investors who do not rely on debt, such as pension funds, are not concerned with meeting debt service obligations. They are, however, concerned with meeting future contractual obligations, a different class of liability. Current low yields do very little for funds with fixed, future obligations.

Leveraged investors, on the other hand, by definition, rely on debt to acquire real property. This group is very much concerned with debt service obligations.

Relatively low interest rates have encouraged leveraged buyers into the market. As interest rates increase, the advantage of leverage decreases and the risk of negative leverage increases.

Selected Government of Canada Benchmark Bond Yields



Source: Bank of Canada



Is the tide still coming in?

There are two variables beyond the control of the individual investor; the amount of capital floating around the markets and interest rates.

One important variable, however, over which the investor has a significant degree of control and over which the investor should exercise control, is the level of net operating income.

The task of the investment manager is to return to first principles. Managers should actively manage, as opposed to allowing the tide to come in on a wave of capital appreciation, with no regard to the efficiency of operations.

Going forward, as the emphasis shifts from gaining value from capital appreciation to gaining value from increased income, a premium will be placed on the professionalism and the ability of investment managers to squeeze efficiencies out of properties.

The basic requirements are easy to state and understand in theory. In practice, the pursuit of cash returns is as much an art as it is a science. An experienced investment manager will constantly be concerned with trade-offs.

For example, is a lower rent accepted in exchange for a better covenant? Is a building upgraded in order to lower operating costs and remain competitive? Is an asset re-positioned in order to increase rents? What tenant mix is required in terms of roll-overs and how does the mix of expiries match financing arrangements?

The list of questions concerning revenues and expenses is almost endless. However, it is within this domain that the investment manager must perform.

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