Avison Young releases Mid-Year 2009 National Office Market Report: pause in leasing demand and rise in sublease space push up Canada's national office vacancy rate, but fundamentals remain intact

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TORONTO, ON, Aug. 5 /PRNewswire/ - Canada's commercial real estate markets continue to wage battle against the economic headwinds that reached gale force status in the fall of 2008. Despite the national economy slipping into recession at the beginning of 2009, office market fundamentals, though shaken, remain relatively intact across most markets.

These are some of the key trends noted in Avison Young's Mid-Year 2009 National Office Market Report, released today. The annual report covers the office markets in 12 regions: Vancouver, Calgary, Edmonton, Regina, Winnipeg, Toronto, GTA West/Mississauga, Ottawa, Montreal, Quebec City, Halifax and Chicago.

With nearly 478 million square feet (msf) of office space spread across Canada's 11 largest cities, the national office market witnessed its vacancy rate climb to 8.5% at mid-year 2009 from 6.1% at mid-year 2008. The downtown and suburban markets both experienced increases in vacancy year over year, rising from 4.4% to 6.9%, and 8.0% to 10.4% in each respective category.

"The rise in Canada's national vacancy rate from 6.1% to 8.5% over the past 12 months has as much to do with fear and the unknown as it does with growth prospects and fundamentals," comments Mark E. Rose, Avison Young's Chair and Chief Executive Officer. "We communicated in our 2009 forecast that this macroeconomic environment would be challenging and pose threats for the future. The global financial crisis has had a significant impact on market psychology, creating inertia and paralyzing decision-making. This was evidenced each day by governmental actions, economic stress and negative media commentary, and confirmed by all known financial metrics."

Rose continues: "Our businesses and occupiers of real estate appear to be stabilizing though, and creating a trough or bottom. Recovery is still somewhat elusive and will occur only when corporate profits return, unemployment rates drop and decision-makers believe we are trending upwards. Until then, we continue to advise our clients to take advantage of lower lease rates, better incentives and buy properties at prices they were unable to underwrite in prior years. Opportunity is always created from dislocation and this recovery will be slow, but opportunistic."

According to the report, unlike the U.S., which is in its second year of what appears to be a much deeper than anticipated recession, Canada is entering this real estate cycle downturn from a position of strength with historically low vacancy rates, a relatively conservative supply pipeline and a much more sound economic balance sheet.

Apart from Mississauga (10.8%) and Halifax (10%), market-wide vacancy rates in Canada remain below the 10% mark. Across the country, overall vacancy rates currently range from a tight 2.3% in Regina, one of the smallest cities and office markets in the country, to a high of 10.8% in Mississauga, a major suburb of Toronto. The central markets of Regina (2.3%) and Winnipeg (4.7%) were the only regions to post a year-over year decrease in vacancy of 10 and 90 basis points (bps), respectively.

In contrast, the Western markets of Vancouver, Edmonton and Calgary witnessed declining office demand levels due to lower commodity prices, especially in the oil and gas sector. Slower leasing velocity coupled with a rising sublet market helped push Vancouver's vacancy rate to 7.4% from 5.0% one year ago. Edmonton, which has benefited greatly from an overheated Calgary market, saw its vacancy rate jump 220 bps over the past year to 7.5% currently. Calgary witnessed the most notable change in vacancy among the Western markets, rising 570 bps to 9.3% from one year prior.

Toronto, the nation's financial centre and largest office market, experienced the most significant annual change among Eastern markets with vacancy climbing 300 bps to close the first half of 2009 at 9.6% - a three-year high. Montreal (8.6%) and Quebec City (4.1%) followed, with increases of 130 and 120 bps, respectively. Finally, continued Federal Government demand kept vacancy in Ottawa (6.8%), the country's capital, relatively in check, rising only 70 bps between mid-year 2008 and mid-year 2009.

Canada's average downtown class A net asking rents dipped from $25 per square foot (psf) at mid-year 2008 to $22 psf at mid-year 2009. On average, net asking rents for downtown class A office buildings across Canada range from a low of $13 psf in Quebec City to a high of $30 psf in Calgary and Edmonton. In Calgary, the emergence of a burgeoning sublease market and imminent new supply has resulted in net asking rents falling $16 and $15 psf for downtown class A and B space, respectively. Meanwhile, in Chicago, the average net asking rate for downtown class A space dipped from C$38 psf at mid-year 2008 to C$35 psf at mid-year 2009.

"Negative absorption of 3.1 msf in the second quarter of 2009 helped notch up the Chicago office market's overall vacancy rate to 15% from 12.7% at mid-year 2008," notes Rose. "Average overall net asking rental rates for all classes of space, currently at C$31.68 psf in the central business district (CBD) and C$21.97 in the Chicago area suburbs, have dipped slightly from the first quarter of 2009, indicating the market is still in a downward trend. The Chicago market will likely continue to soften over the next quarter with further erosion expected in rental rates. Hence, landlords will need to tighten their belts and work harder to maintain existing tenants, as replacing tenancy will be difficult for the balance of 2009."

Rose adds: "It is important to note that real estate is viewed as a lagging indicator to the rest of the economy of between 12 to 24 months and it will be interesting to see how the various office leasing markets perform in the coming quarters. The remainder of 2009 will likely be a period of continued volatility; however, Canada is well positioned to emerge from this downturn in relatively good shape. A tenant's market will persist, while for many landlords, preservation of income will be the key."

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The following is a snapshot of the office markets in the major regions:
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VANCOUVER

Vacant sublease space rose in all eight of Metro Vancouver's office submarkets during the first half of 2009, which notched up the region's vacancy rate to 7.4% at mid-year 2009 from 5.0% at mid-year 2008. "Deal velocity was low during the first half of this year as firms continued to downsize, consolidate and cut costs by attempting to sublease some of their surplus office space, most of which still remains vacant," comments Avison Young Principal Bill Elliott in Vancouver. "Downtown vacancy doubled from 2.5% at mid-year 2008 to 5.0% at mid-year 2009 while the suburban vacancy rate bumped up to 9.1% from 7.2% at mid-year 2008.

Vacant sublease space in Metro Vancouver totalled 948,872 sf at mid-year 2009 triple the 304,395 sf recorded at mid-year 2008. The downtown core currently accounts for 460,158 sf of the vacant sublease premises. Elliott notes: "Tenants seeking larger blocks of space downtown still have limited choices as most of the sublease spaces are smaller pockets, which indicates the economic slowdown has affected industries across the board."

Overall absorption was negative 674,349 sf between January 1 and June 30, a far cry from the five-year annual absorption average of 1.1 msf. Downtown, tenants left behind -487,775 sf more space than they took up during the first six months of 2009. "This amount of space is similar to that of a new office tower," points out Elliott. "Competing with attractively-priced sublease opportunities, some landlords are now more aggressive in securing quality tenants and maintaining existing ones." Vacancy levels are expected to tick up by year-end as companies continue to restructure. However, new speculative construction is in check and no major downtown tower is slated to come on stream before 2013.

CALGARY

During the first six months of 2009, the Calgary office market witnessed one of its slowest periods in history where deal activity was concerned. "Calgary's steadily growing sublease market and formerly booming construction market have resulted in vacancy rates that continue to rise, as evidenced by the three-percentage-point increase over the past six months to 9.3%," comments Avison Young Principal Todd Throndson in Calgary.

He continues: "Vacancy has increased dramatically and is forecast to continue rising as new construction and sublet space create more availability of space. Having said that, we expect the number of transactions to increase as rents continue to drop, enticing tenants to make decisions."

Throndson says there will be high levels of tenant movement as new buildings are completed in 2009 and 2010, which will help counteract some of the negative absorption and further vacancy increases projected for the near term. "Overall, Calgary vacancy rates are expected to continue rising for the next 18 months, while absorption of office space is anticipated to remain negative for the balance of 2009."

EDMONTON

With a current vacancy rate of 7.5%, Edmonton has maintained relatively strong standings in the office market. Contributing to the health of the office market in the first half of 2009 was the minimal amount of sublease space that returned to the market. At mid-year 2009, sublease vacancy totalled 0.6%, a significantly lower rate than in most other major markets. Net rental rates plateaued at the beginning of 2009 and have decreased slightly since then, depending on the specific vacancy situation of a building.

"Despite increases in overall vacancy, vacant office space in Edmonton continues to be less noticeable than in other major Canadian markets," says Avison Young Principal Cory D. Wosnack in Edmonton. "However, while the market stabilized in the first half of 2009, we are watching how it reacts to two significant forthcoming announcements that will result in a combined 110,000 sf of space being put on the market in Telus House and Sun Life Place. This will increase the amount of available space in the downtown market by 0.7%."

Wosnack adds that three large lease transactions were concluded in June 2009, representing sizable growth to the market. These include Sobeys for 97,000 sf, Enbridge for 63,000 sf, and ATB Financial for 27,000 sf. "These are examples of financially stable organizations that are taking advantage of a softer market to secure appropriate space on more economical terms compared to 2008," he says.

REGINA

In contrast to most other regional markets, vacancy in the Regina office market decreased to 2.3% at mid-year 2009 from 2.4% at mid-year 2008. Downtown office space continues to be in demand as space is very limited.

"Plans for new construction have been ongoing for some time; however, the global economic downturn and tight credit conditions have delayed new inventory coming to the market," comments Avison Young Principal Dale Griesser in Regina. "With no new construction in the office market for nearly a decade, rental rates have edged upward. New downtown projects are being contemplated with rental rates expected to exceed $30 psf." Rents for existing class A space currently range from $19 to $25 psf, while class B space leases for $14 to $17 psf. Class C premises hover in the $10-psf range.

"The decline in vacancy indicates a trend toward small lease and sublease arrangements, or expansion of existing tenant space. Tenants are making do with what they have, given the limited supply and market-corrected prices on new space or renewals," says Griesser. Going forward, he says the Regina office market is anticipated to hold steady for the remainder of 2009 and well into 2010 as demand continues to exceed supply. "Vacancy rates are expected to stay at an all-time low. Tenant inducements will also remain unchanged as all stakeholders move through the wait-and-see period toward broader economic certainty."

WINNIPEG

Winnipeg's healthy and resilient economy has served it well during the global economic slowdown, and the office market has remained remarkably strong in contrast to many other major North American municipalities. According to the Conference Board of Canada, Winnipeg's GDP growth is anticipated to rank first among major Canadian cities in 2009 at 1.1%, and is forecast to further increase to 3.0% in 2010.

"Winnipeg's office market is behaving very well these days, and many tenants have the confidence that landlords want to see," says Avison Young Principal Wes Schollenberg in Winnipeg. "Some long-term deals are becoming increasingly complex, and more creativity is required by all parties to make them work. Nonetheless, ongoing economic expansion, combined with very little new office inventory anticipated over the next 12 to 24 months, will result in Winnipeg's office leasing market continuing to perform strongly into 2010."

Winnipeg's downtown class A market, which comprises 2.4 msf, witnessed a net vacancy decrease of 0.1% from the second quarter of 2008 to 4.7% currently (or 113,400 sf). The class B market, which encompasses 2.7 msf, experienced a 4.4% increase in vacancy to 9.9%, or 269,637 sf, due to the move of two significant public sector tenants to newly constructed premises in the downtown core. Winnipeg's office sublet market has remained flat with a net decrease of 16,110 sf of class A sublet space and an increase of 8,574 sf of class B sublet space since the second quarter of 2008.

MISSISSAUGA

Office construction in the GTA West is expected to continue delivering modern, LEED-certified product into softening market conditions through 2009 and early 2010.

"While preleasing will offset some of the added inventory, it is expected that vacancy rates will continue to increase as excess space takes time to lease, especially given that further staff reductions are expected through 2009," comments Avison Young Principal Martin Dockrill in Mississauga.

Going forward, rental rates are anticipated to further soften in the second half of 2009 as more tenant options become available. "GTA West landlords will be aggressive to secure new tenancies and retain existing ones. Landlords will also be willing to trade flexibility for rate as they look to stabilize asset income," says Dockrill.

TORONTO

The economic headwinds that reached gale force status in the fall of 2008 have shaken leasing fundamentals in the country's largest office market to the point where performance has been less than stellar. "Shrinking balance sheets, forcing many companies to downsize and or postpone expansion plans, along with new supply, have pushed the overall office vacancy rate across the Greater Toronto Area to 9.6%. Not only is this a 300 bps jump from one year earlier, it is also a level not seen in three years," says Avison Young Principal Mark Fieder in Toronto.

Unlike one year ago when a landlord's market prevailed, the pendulum has now swung clearly in the tenant's favour, especially in downtown Toronto. Though vacancy is up 340 bps from one year ago to 7.6% currently, it remains well below the recent peak of almost 12% in 2003.

"However, office space that is marketed for lease (on either a direct or sublet basis) but is not yet vacant results in an availability rate of 9.8%. These impending vacancies, along with 3.7 msf in the supply pipeline, of which almost 2 msf (69% preleased) is scheduled to be completed over the next nine months, has created a tremendous window of opportunity for the occupier community," explains Fieder. "Given the bountiful options in the market, tenants of all size categories are taking the necessary steps to establish the leverage to either move up the space spectrum and/or reduce occupancy costs, even with two to three years remaining on the lease."

Fieder says this window is expected to remain open as vacancy/availability is poised to breach the 10% barrier and settle in the low- to mid-teens in the coming quarters.

OTTAWA

Based on office vacancy levels, Ottawa's market continues to perform relatively well. "At mid-year 2009, Ottawa's overall vacancy rate sat at 6% - a slight bump up over the same period last year. The uncertainty at Nortel influenced what should have been a flattening of the region's overall vacancy rate," points out Avison Young Principal Michael Church in Ottawa.

He continues: "Of note this year was Public Works and Government Services Canada's (PWGSC) first foray into the Kanata submarket with 60,000 sf. This was a welcome change in the struggling submarket, which still has in excess of 20% vacancy."

Meanwhile, the sub-3% vacancy rate in the core is one of the lowest in the country. Minto's180 Kent Street project, with 380,000 sf of new LEED gold standard construction, will open this year 80% occupied. "The balance of the region's remaining large blocks of contiguous space will remain off core with Minto's project holding the last block of significant space downtown," says Church. "Overall, the commercial office market remains healthy in the expected core office nodes and major transportation corridors, but trends along the south and west end market transportation corridors warrant careful attention."

MONTREAL

Aside from larger tenants looking for premises greater than 30,000 sf, there are still plenty of options available in the Montreal office market. The region's downtown vacancy rate increased two percentage points from a year ago to 7.8% at mid-year 2009. In addition, the amount of vacant sublet space available in the downtown core has more than doubled over the last year, resulting in a current sublease vacancy rate of 1.3%. Suburban vacancy rates have remained relatively stable.

"Generally, landlords are maintaining their net rental rates; however, we have noticed that landlords are prepared to offer greater incentive packages in the form of free rent or allowances to incite tenants to close transactions," comments Avison Young Principal Bernard Poliquin in Montreal. "A continued softening of Montreal's export market will result in weaker income gains. The local economy is expected to contract further in 2009 by 0.5%, but experience positive growth of 2.9% in 2010."

Poliquin adds: "Construction of a new office building in Montreal's downtown core has yet to commence, as prospective developers need to secure a major tenancy before proceeding. Over the upcoming year, we expect to see continued negative absorption and deferred decision-making among tenants until there is a clearer indication of where the economy and Montreal's office market are headed."

QUEBEC CITY

Forecasted economic growth for Quebec City in 2009 is 0.6%, which exceeds growth expectations for Toronto, Montreal, and Vancouver. "We are in a very favourable position and have little to complain about here in Quebec City. The outlook for economic growth is positive and vacancy rates have remained low," explains Claude Pellicelli, VP of Avison Young's Quebec City office.

"Unlike most other Canadian cities, Quebec City does not have a single square foot of office space available for sublease," stresses Pellicelli. "A good proportion of the new suburban vacancy is from new developments reaching completion. We saw a small spike in suburban vacancy levels over the past year, rising to 5.2% at the end of 2009's second quarter from 3.0% a year ago, which coincides with the completion of some new developments in the North-West and Sainte-Foy districts."

Downtown vacancy rates have improved to 2.6% currently from 2.7% at mid-year 2008. The city's average net asking rental rate has also increased over last year's rate by more than 5%. "Moving forward, the addition of approximately 1 msf of new space in 2009 and 2010 will likely put pressure on both rental rates and vacancy rates. Hence, the city's overall vacancy rate is anticipated to increase to 7% by 2010," he says.

HALIFAX

While the Halifax economy has generally fared well compared to other parts of the country, the effects of the recent economic decline did find their way into the Halifax office market during the first half of 2009. "Deal activity was certainly slower during the first six months of 2009 than during the same period last year," comments Avison Young Principal Kenzie MacDonald in Halifax.

"On a brighter note, local developer Rank Inc. has announced it will be constructing a new project that will change the landscape of downtown Halifax. The new development, Nova Centre, will be a global trade and finance centre and will reshape two downtown city blocks. This 1.2-msf development will comprise an 18-storey hotel, a 14-storey office building, 300,000 sf of convention space as well as retail and residential spaces."

MacDonald says there are currently signs that the local economy has already started improving and, as a result, the office leasing market is expected to witness increased activity during the second half of 2009. "We expect vacancy rates to decline slightly, with rental rates remaining relatively flat through to year-end," he says.

CHICAGO

At mid-year 2009, the Chicago office market registered an overall vacancy rate of 15%, up from 12.7% at mid-year 2008. During the second quarter of this year, both the central business district (CBD) and the suburban markets experienced negative absorption (-995,788 sf in the CBD and -2.1 msf sf in the suburbs), resulting in negative 3.1 msf in overall absorption.

"The class A office market bore the brunt of that negative absorption at negative 1.9 msf, while class B space was less affected at negative 702,283 sf. Class C space witnessed negative 511,986 sf of absorption in the second quarter," explains Avison Young Principal Michael McKiernan in Chicago. "Rental rates for the market also showed a decrease of 1.4% in the second quarter of 2009 over the previous quarter, which demonstrates the market was still in a downward trend." As of mid-year 2009, the average quoted asking rental rate was C$31.68 in the CBD and C$21.97 in the suburbs. Both averages were down slightly from the first quarter.

He continues: "The Chicago market, both suburban and CBD, will continue to soften through the next quarter. The CBD will start to see erosion in the psf asking prices and suburban rates will continue to fall. So even though the Chicago market is a large, vibrant and diverse economy, landlords will need to take care of their tenants as replacing tenancy will be difficult for the next few quarters."

There is currently 3.7 msf under construction in the Chicago marketplace, with two projects accounting for 2.3 msf: the 1.2-msf Mesirow Financial Building, which is 76% pre-leased; and 155 N. Wacker Drive at 1.1 msf, which is 68% leased. McKiernan adds that there has been no significant sales activity in the office sector since the sale of 135 S. LaSalle Street in the CBD. "The building sold for C$204.1 million or C$162.21 psf on July 31, 2008, just prior to the credit crisis," he says.

Founded in 1978, Avison Young is Canada's largest independently-owned commercial real estate services company and the only national, Canadian-owned, principal-managed real estate brokerage firm in the country. Headquartered in Toronto, Ontario and ranked among Canada's leading national commercial real estate organizations, Avison Young is a full-service commercial real estate company comprising more than 500 real estate professionals in 12 offices across Canada and in Chicago, IL. The company provides value-added, client-centric investment sales, leasing, advisory, management and financial services to owners and users of commercial, industrial and multi-residential real estate properties.

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