



The Mighty Maple Leaf

Investors skate to stability in Canada.

by Daniel Duggan

With an economy based on a strong banking sector and an ample supply of natural resources, Canada's early emergence from the global recession has real estate investors getting off the bench.

The Canadian real estate investment market saw a strong increase in 2010, particularly toward the end of the year as debt and equity started to fuel deals. The 2010 total was \$18.9 billion in investment, a surge of 47.9 percent year-over-year from the \$12.7 billion in 2009, according to CB Richard Ellis — close to the \$19.8 billion of peak investment year 2005.

"From an overall perspective, foreign investors are being drawn to a stable,

well-run investment market driven by the strength of the banking system," says Jim Becker, market director for Michigan, Ohio, and Canada for Chicago-based Jones Lang LaSalle. "It's now being seen as a safe haven with low corporate taxes, a high tax base, and an attractive environment for businesses."

But despite its stability, Canada attracted only about \$249 million — 1.6 percent — of its total 2010 investment volume from outside the country, according to CBRE.

Trophy Assets Hard to Find

Part of the reason for lackluster foreign investment may be high entry barriers to

the trophy office market — especially in Toronto, where just a handful of institutional investors hold all the class A assets.

Toronto, Canada's largest office market, revolves around the banking sector and has shown improvement based on gains in the financial sector, says Robin White, executive vice president in the investment group of Avison Young, a national real estate firm based in Toronto.

"In the big picture, Canada never found itself in the same troubles as the U.S. and Europe," he says. "We've skated through better than some and the banks are in good shape, making stellar profits at this point."

The Toronto office market remains tight, with a vacancy rate less than 9 percent and only seven options for tenants needing more than 100,000 square feet, according to Jones Lang LaSalle research. Controlling most of the city's trophy assets are the Big Five banks headquartered in the city: Royal Bank of Canada, Toronto-Dominion Bank, Bank of Nova Scotia, Bank of Montreal, and Canadian Imperial Bank of Commerce.

In fact, roughly 90 percent of the office product in Toronto is controlled by those five entities — and don't even think about buying, says Becker.

"With the competition to own these assets, you might think the owners would see their chance and take their money," says Becker. "But that's not the case. They want to keep their chips in the pot."

The hesitation to sell also comes from the need for most funds to have income-producing assets to fulfill investment goals, says White. "They've been reluctant to sell because they're not quite sure how they'll re-invest again."

But with capital ready to be invested, the lack of available office product is pushing institutional deals into the suburbs and away from core assets. "[Investors] are forced to look farther afield," White says. "As a result, suburban assets — grocery-anchored retail, things that are well-leased and income-producing — are appealing."

Most new office product is being built in Toronto's suburbs, with 1.5 million square feet delivered in 2010 and 1.2 million sf in the pipeline this year.

In Montreal, an older stock of office properties — built up before the major banking institutions moved to Toronto — is now being converted to exposed brick, urban office space, says Phil Dowd, a vice president in the Toronto office of Jones Lang LaSalle. That stock has drawn a steady base of creative companies such as video game development teams and the research and development arms for pharmaceutical companies.

"It's a very well-preserved city, and it's built up a sophisticated office market," says Dowd. "The video gamers love the brick-and-beam office stock."

CANADA'S OIL PLAY

While fear spreads over the geopolitical chaos involving Middle Eastern oil, Canadian oil becomes more and more appealing.

A major economic driver for the country comes out of the Alberta province, where oil exploration, transportation, refining, and research dominate the industrial market. The oil sands deposits in Alberta represent the second largest oil reserves in the world, with 178 billion barrels of oil reserves. Producing close to 3 million barrels a day and exporting 1 million per day, Canada's oil industry is a huge economic driver.

A tight vacancy level in the 4 percent range combined with increased demand has speculative real estate projects on the drawing board. Scott Hughes, CCIM, SIOR, managing director of Integrated Management and Realty in Edmonton, says growth in oil-based industrial is highly likely. If the current export level of 1 million barrels per day is pushed to 2 million or even 3 million barrels, he says, the demand for commercial real estate will follow.

"To make that kind of a move, to grow like that, would require a substantial investment in the infrastructure," he says. "New pipelines, manufacturing, and transportation would all be needed."

Greater Edmonton, with a 96.6 million-square-foot universe of industrial product, saw a vacancy rate of 4.4 percent in 4Q09 drop to 3.6 percent by 4Q10, according to data from Edmonton-based Colliers Macaulay Nicolls.

New construction, just under 1 million square feet in 2010, outpaced 2009 significantly, but is far from the more than 3 million sf built in 2008, according to Colliers.

Net rent in the region ranges from a low of \$6.10 psf to a high of \$15.00 psf based on the size of the location and the region.

Retail Fuels Industrial

In other real estate sectors, a trickle-down effect is in place, fueled by U.S.-based retailers looking north to expand market share. "In Calgary, Montreal, and Toronto, our clients are building to serve a large consumer retail market," Becker says. "There is a lot of disposable income in Canada, and Home Depot and Target, for example, are recognizing that and making moves."

In January, Target Corp. spent \$1.8 billion to acquire more than 200 Zellers locations across Canada. The retailer plans to convert most of the stores to its Target format. Lowe's, which entered the Ontario market in 2007, is moving into western provinces, opening stores in Calgary, Alberta, British Columbia, and Saskatchewan.

Kohl's, Marshall's, J. Crew, and J.C. Penney are getting ready to enter the country as well, says Sandy Shindleman, CCIM, SIOR, president of Winnipeg-based Shindico. "There is definitely an uptick in retail deals," he says.

That retail growth is fueling industrial real estate as well, as warehouses and distribution centers are needed and logistics companies are booming with the new business to move retail products.

"Distribution is a big part of the Ontario industrial market," says John O'Bryan, vice chairman of CBRE Canada.

The segments of the industrial market based on automotive and other manufacturing were hurt badly by the recession, he adds. "Cap rates are back to 2007 levels in many areas. But the rental markets haven't kept pace, particularly in industrial. Manufacturing took it on the chin, so areas such as Ontario, closely associated with automotive, were bashed."

And while manufacturing has lagged on the industrial side, the natural resources component of the country's economy has been strong with growing demand for oil outside the Middle East. Mineral-rich portions of the country have been a driver for industrial

growth surrounding the country's oil supplies and the industry of transporting it, refining it, and exploring for it. (See sidebar.)

Residential development has followed the natural resources-related industrial growth in some of Canada's key mineral regions. In an oil-rich market like Alberta, jobs are being created in direct proportion to oil production, said Scott Hughes, CCIM, SIOR, managing director of Integrated Management and Realty in Edmonton.

"For every 1 million barrels of oil produced, you need 20,000 workers. And every barrel that is produced right now is sold," Hughes says.

Multifamily Demand Stays Strong

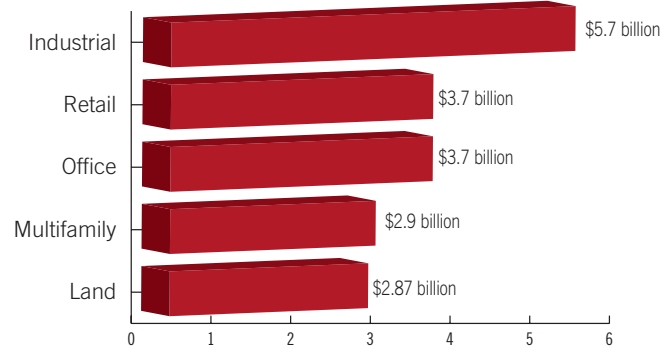
The British Columbia segment of Canada's multifamily market is the most active. In the Vancouver market, an explosion in residential/multifamily development is following a boost in rents and an infusion of new investment.

"The market for Pacific trade in Canada comes right through Vancouver," says Dowd.

In 2010 there were 20 transactions for a total dollar volume of \$264 million, largely in Vancouver. Vacancy ended 2010 at 1.9 percent. Cap rates are in the low 4 percent range, according to Avison Young, with cities outside Vancouver approaching 6 percent. Cap rates for trophy assets remain compressed and in the 3 percent range.

However, rent controls are holding back some of the multifamily values in many of the markets, says Avison Young's White. "Residential has been a strong sector," he says. "But with the rent controls in some of the markets, you're not seeing the value that you would see otherwise."

2010 CANADIAN REAL ESTATE INVESTMENT MARKET



Source: CBRE

Multifamily cap rates range from 5 percent to 5.7 percent in Calgary and from 6 percent to 6.7 percent in Montreal, according to Colliers.

Tight market conditions are expected to push Toronto rental rates higher, with immigration being a key driver in the market, according to CBRE. In the Greater Toronto area, the rental vacancy rate fell from 3.1 percent in 2009 to 2.1 percent in 2010, with a further 1.8 percent drop forecasted for 2011, according to CB Richard Ellis. Cap rates in 2011 are expected to be in the 6.2 percent to 6.5 percent range.

New condominium completions are adding to the secondary rental pool in Toronto as first-time homebuyers are taking a wait-and-see approach, opting to rent until the market settles.

Forecasts for the remainder of 2011 call for continued growth in Canada's real estate investment market as the banking sector expands and capital continues to flow from the renewed interest by institutional investors and real estate investment trusts.

"Overall, it's a relatively boring economy," says CBRE's O'Bryan. "A relatively good banking system and natural resources are among the strong pillars that have held up the economy."

Daniel Duggan writes about commercial real estate for *Crain's Detroit Business*.

OUT-OF-TOWNERS NEED NOT WORRY ... BUT BRING A LAWYER

Thinking of buying in Canada? Not a large worry, but do your homework.

To date, investment in Canada has been a game largely for Canadians, with less than 2 percent of real estate investment coming from foreign investors.

That need not be the case, says Sandy Shindleman, CCIM, SIOR, founder and president of Winnipeg-based Shindico. Nearly half of the brokerage practice at his firm is based on retail, a sector showing large interest from U.S. investors chasing the U.S. retailers entering Canada.

"The real estate in Canada looks the same and acts the same as the real estate in the United States," he says. "Leasing contracts are similar and the idea of a net lease is very common."

He adds that the tax treaties between the U.S. and Canada keep many tax issues from becoming complicated; for example, taxes paid in Canada are credited in the U.S.

Developers typically have engaged Canadian firms or used joint-venture structures to navigate the local issues that exist from market to market.

Investors sometimes use Canadian firms for due diligence. But it's best to hire a local counsel in that area, says Mark Rubenfire, a partner at the law firm of Jaffe, Raitt, Heuer & Weiss PC in the suburbs of Detroit.

"Issues related to title, local tax laws, things of that nature really are best handled by a local counsel to ensure you're getting the right advice," he says.

And pay attention to the exchange rates, he adds.

"Changes in the exchange rates can change the deal," he says. "If you get a swing in the rates, you could wind up making money off the currency play as well."