



# Back to the *streetfront*

**Narrowing your search for a profitable commercial asset may be tricky with so many options. However, one area in particular – streetfront property – is gaining momentum in today’s market. Kit Kadlec reports**

**F**or nearly two decades, big box retail has seemed an unstoppable force, swallowing up and pricing out the smaller local stores. Nearly every community has seen its share of this as Wal-Marts and Costcos move in.

But in 2010 for Canadian investors, it may be streetfront retail that holds some of the most promise as focus returns

to those areas. Big box is no longer the only option for the lowest priced goods – the Internet is often a more convenient and sometimes cheaper choice. And many consumers are finding they still want that local neighbourhood touch when they go out. They want a friendly connection with their local stores.

“You frankly don’t get that in

most big box stores, and you don’t get it when you’re shopping online,” says Mary Mowbray, manager of the retail group in Toronto at real estate brokerage Colliers International.

Big boxes in Canada have also been hurt by the fact many American-owned companies have pulled back due to their own economic issues. Arlyn Stoik,

principal with Edmonton-based [Avison Young's](#) retail division, says the large box retail formats (10,000 square feet and up) have started to show some increasing vacancies in Western Canada.

“We’re having a tougher time filling those vacancies just because the larger-scale tenants, especially those tied to the United States, are slowing down,” he says. “We don’t really see them coming back to the marketplace probably until 2011.”

Where there’s strength is in the smaller service industry shops such as fast food, where there’s very little vacancy and little turnover, says Stoik. And often, that’s in streetfront – defined commonly as a retail fronting to a street, parking in front and rear, and usually separately owned. There’s a financial advantage in streetfront in that you aren’t dealing so much with new construction as you would with box stores.

Across the board in retail, national or American tenants have decreased, leaving room in 2010 for a return to local tenants.

“With the nationals pulling back, we’re starting to see some of those regional and good local tenants take some space in some of those shopping centres or good streetfront retail,” says Stoik. “So there’s opportunity there, and I think landlords have to recognize that category of local or regional tenants.”

There’s also an insurgence of people moving back towards cities’ downtowns, as is seen in Toronto. They are often the types who prefer the local shops as well.

“People don’t want to live an hour-and-a-half out in the suburbs,” says Mowbray. “They will accept, or maybe even prefer a smaller environment, but they want a neighbourhood there and they want to walk and get coffee in the morning.”

### Following the artists, and timing carefully

When starting out as an investor in retail streetfront, forget the building and the investment – first you need to pick the area, says Mowbray. As with any real estate, streetfront location is essential to its success for an investor. She says investors need to ask themselves first if

## 2008 versus 2009

### Average rental rates in Toronto

| Retail product type          | 2008       | 2009      |
|------------------------------|------------|-----------|
| Commercial Retail Unit (New) | \$24-\$28  | \$19-\$24 |
| Big Box (New)                | \$17-\$25  | \$13-\$21 |
| Pads (New)                   | \$30-\$45  | \$25-\$40 |
| Streetfront                  | \$30-\$100 | \$25-\$90 |

Source: Cushman & Wakefield

they’re looking for an established area or an up-and-coming one.

If it’s the latter and you’re hoping to catch an affordable neighbourhood on a transition up, you need to look for some important signs for that optimism. Following the artists is one popular way to go, although it takes some research and willingness to accept risk.

“Artists go there first because the rents are cheap, but they also give the neighbourhood that whole Bohemian, neat, cool cache feel – you know, like ‘we found this area,’” says Mowbray.

If all goes to plan, the wealthier younger crowd moves in soon after, attracted by the offbeat shops and the feeling they are discovering something new.

It’s going to be riskier, but you have higher asset appreciation. “You could go for a building with no tenancy in

Mowbray gives as an example a friend who bought a property 10 years ago in Toronto’s Queen Street West for \$600,000. He renovated the top two floors into a “stunning” loft apartment, and rented the bottom floor streetfront shop out to a Canadian fashion designer. The property has since doubled in value, she says.

“He probably could have bought it for less 10 years before that purchase date as well, but he wouldn’t have been able to get this designer as a tenant,” Mowbray says. “He would have been leasing to some retail variety store or something, and his rent would have been probably \$15/foot instead of \$30 or \$35.”

### Prime retail strips are performing in major cities

Buying in an established area is also another option for your streetfront investment. In this case, less intuition is needed, but research into the area is still important.

Retail property analysts often suggest sticking near popular grocery stores. Food-anchored shopping centres in Vancouver, for example, had a vacancy rate of less than two per cent last July, according to Colliers International’s third quarter report.

“Look for traffic generators, and

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an up-and-coming area and do far better than sort of a flat area with lower income around it and there’s never going to be any really high demand,” Mowbray reasons.

She cautions the higher risk area may sometimes take longer than one might think to turn around, however. Judging this timing can be somewhat scientific, but also requires some intuition as well.

Timing makes all the difference, however, between a dud investment and a great one.

grocery is a great traffic generator,” says Stoik. “Anything that will bring people to a site.”

Darren Snider, a principal for [Avison Young](#) in Edmonton as well, says you need to look at what will draw people to your property.

“With streetfront, it’s the neighbourhood. It’s the pool of retailers that locate on the street with you,” says Snider. “You want to be a destination, and you want customers to be coming to you if not once a



## The ups and downs of streetfront retail

### Positives

- ▶ Commercial tenancies are generally easier to manage and longer. A typical lease is five years as opposed to a one-year residential one.
- ▶ It's easier to eliminate a tenant who is late on payments. With a commercial property, you can lock out your tenant in seven to 14 days who hasn't paid you.
- ▶ You can increase rents accordingly. Unless there's an option in the contract, there is no limit to what you set your rates at. In the right areas, rents are rising considerably, even in a weaker economy.

### Negatives

- ▶ Economy has made finding tenants more difficult in many areas, and thus more risky.
- ▶ Financing is more difficult as rates are higher. Other costs are higher as well such as required environmental reports.
- ▶ More money is required down, and the cost to get in is considerably higher for one property than residential on average.

Source: Ernest Furtado of Keller Williams

week, two or three times a week.”

Sometimes the reputation of the neighbourhood is in itself enough of a draw. The higher up you're willing or able to spend as an investor, that prime neighbourhood for streetfront can reach the scale of Bloor Street in Toronto or Robson Street in Vancouver, where rents can reach from \$200 to \$300 per square foot and beyond.

For those who can afford it, and that can often mean sales tags in the millions, the returns right now are worth it, says John Crombie, National Retail Director for Cushman & Wakefield Ltd. in Toronto. There's consistency in the high end.

“You've got to take the best retail strips – that's where you'd want to invest,” he says. “We haven't seen a downturn there.”

A lack of competition for these luxury

retail properties is often what keeps them in high demand.

“In Toronto, the premium area is two blocks,” Mowbry says. “There aren't a lot of options. If a luxury retailer wants that (prime) market, which is often why they are there (for that marketing function), they can't go over three blocks and save money.”

The associated benefits just aren't there unless you're on that prime strip.

### Financing

The difficulty right now can be financing, but that's started to loosen up heading into 2010, says Crombie. Still, you need more money down in commercial properties than before. Loan-to-value ratios (LVRs) went from as high as 70 per cent to closer to 50 per cent lately in Toronto, says Crombie.

Residential properties are still offering

LVRs closer to 80 per cent. Buying an owner-occupied property in pristine condition can help that LVR be higher in commercial lending, says Ernest Furtado, director of Keller Williams Referred Realty's commercial division. But even with that, the best you can hope for now is about a 75 per cent LVR, he says.

The finance environment has led many investors to sit on their hands. Everything, for the most part, is more difficult than residential.

“It's always been more difficult to get a commercial loan,” says Furtado, who has 27 years of experience in nearly all varieties of real estate investments.

A residential loan approval might take five days, for example, whereas a commercial property takes anywhere from two to three weeks, he says. It's also more expensive. A residential appraisal is \$300, compared to \$750 to \$1,500 for commercial.

Commercial properties also require an environmental report, checking for past contamination, which can range from \$1,200 to \$2,000 in Toronto.

And then there's the fact lending rates are considerably higher, usually about two percentage points more than residential. So if the residential lending rate is four per cent, expect a streetfront retail rate to be closer to six per cent, says Furtado.

But despite the financial difficulties, Furtado says there are still lots of reasons to prefer a commercial investment such as streetfront retail as opposed to residential.

One reason is commercial tenancies are generally easier to manage and longer. A typical lease is five years, as opposed to a one-year residential term.

When that expires, it's also much easier to raise rents. Furtado says a property Keller Williams managers on Bloor Street that just finished a five-year term with a \$38 rent per square foot has been raised to a new rate of \$60.

And if you want to get rid of a streetfront tenant who is not making payments, you can force them out in seven to 14 days, says Furtado, unlike the drawn out residential process.

Although they've struggled more lately, the national tenants often are associated with a lower risk of vacancy. They often have deeper pockets and more experience operating. But that's no guarantee either

#### Pricing your rent, and the cost of vacancy

Although they've struggled more lately, the national tenants often are associated with a lower risk of vacancy. They often have deeper pockets and more experience operating. But that's no guarantee either. A Nike store in a Toronto shopping area recently closed in just three years, says Mowbray.

From the owner's point of view, vacancy is one of the biggest risks in real estate.

You have to get a tenant in there when you buy it, but also after you get a tenant who has gone out of business. For that

reason, finding a tenant who can stay long term can make a major difference.

Finding a comfortable price range is important. Generally speaking, when pricing the rent it's best to stick near what others on your block are charging. That may even hold true if you think you've bought into an up-and-coming neighbourhood, and you've started to see some of the early signs of things improving. Thus, the question of raising rents is a challenging one.

There can be a tendency on owners' parts to push the rents really high as soon as they see property prices in their

neighbourhood going up. But, proceed with caution.

"As an individual owner, if you get your rent out of sync with the market you're in, it's only because you've got an unsophisticated tenant that was prepared to do that," says Mowbray.

Mowbray offers a scenario where everyone in a particular streetfront retail area is paying \$35 to \$40 per square foot, and someone then charges \$50 and gets away with it.

While that owner might get more money upfront, if that price proves unsustainable and the tenant goes out of business, it can result in a major investment loss.

"As an owner, you need to remember that any vacancy cost you incur is very hard to make up," says Mowbray.

If you have a building generating \$10,000 a month, and you go to lease it, and for some reason it sits vacant for six months, you have a \$60,000 lost

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net income, plus other costs. It's nearly impossible to make that up in the short run at least. So instead of risking such a loss, owners are often better off taking the lower rent, say \$40 as in the example above, and getting a stable tenant in place.

Other strategies could be to sign shorter leases with no options, although many national tenants prefer longer leases.

Where there are already vacancies, landlords might be best offering a short-term lease, says Stoik. "In some cases, it's best to get a tenant in there paying rent," he says. "You're taking a bit of a risk, but in some cases those things can turn into longer-term tenancies."

Snider recommends strong

had a rent around \$30 per square foot, according to Colliers.

It's also essential for anyone getting into commercial real estate to understand the cap rate, which averaged near eight or nine per cent in the Greater Toronto Area (GTA) last year, and is calculated by dividing the annual operating income of the property over the purchase price.

Succeeding at that lower price level will likely mean going to either a smaller market or finding a transitional neighbourhood in a major market. Doing so requires some diligence and that ability to recognize signs of improvement.

That can mean determining if there's a local or independent coffee shop, a good

Stoik says the strengths were in food and drug, value-oriented retail, and fast food, especially those businesses driven by franchising. Where some pullback was noticed was in furniture and home improvement, as well as fashion.

Snider says the furniture and home improvement often lags behind the housing market, so that could start to change this year.

But despite a down year in 2009, vacancy rates in Edmonton are slightly above three per cent, says Snider, and most of the western part of Canada is looking strong overall.

"There are many investors across the country that would look to Edmonton



## Best areas to invest for Toronto

### Performing well now:

- Bloor Street – Avenue to Yonge
- Yonge Street at Dundas or a block or so north of Dundas
- Bayview – Leaside
- Bloor Street – Annex: numerous quick service restaurants, interesting retail

### Up and coming:

- Queen Street East – Leslieville: There's a lot of restaurants and interesting independent retailers
- West Queen West, around Niagara and Tecumseth and further west around Ossington
- Mount Pleasant, south of Eglinton

Source: Mary Mowbray of Colliers International

communication between the owner and the retailers.

"You need to know how they're doing before there's a problem," he says. "You want to know ahead of time if you're going to have a vacancy so you're going to be able to go to the market and fill it ahead of time."

### Operating on a smaller budget

Bloor Street is not for everyone. Some investors can only really afford the lower 10 per cent to 20 per cent of streetfront retail properties, which could mean perhaps a building around \$500,000 in Toronto.

The variation in markets is huge, however. While Bloor Street rents around \$300 per square foot and up, in the booming resource city of Saskatoon, the top street area last year

national store, and analyzing housing prices in the area to start, says Mowbray.

"If you start to follow a city, and you start talking to people who know real estate, they can tell you, 'Here are five potential markets to look at,'" she says.

### Market outlook

For Western Canada, Avison Young says it was Manitoba and Saskatchewan that had the strongest performances in retail last year, whereas British Columbia and Alberta lagged. Snider points out Alberta had been through nearly 10 years where there was same-store growth of five per cent to 15 per cent, whereas in 2009, some retailers had same-store growth as low as negative 10 per cent to 15 per cent.

"Balanced with the incredible years we've had, it's kind of to be expected," he says.

In terms of categories of tenants,

or Alberta as being a great place to buy retail real estate," he says.

To the eastern part of the country, Mowbray says the essentials of grocery, drug stores and financial services will continue to do well. She also sees quick service food staying strong, as frugal consumers go to more affordable meal options.

In Ontario as out West, fashion will likely have a tough year. Mowbray says although some individual players may still do well. Overall, things are improving, but Toronto won't likely see too much of an upwards shift yet, says Crombie.

"Even though we are seeing greater stability in Toronto's retail real estate, we can never ignore the tremendous influence the U.S. has over Canada on both consumer confidence and lending practices, which will directly affect the speed of local recovery," he says. ■