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Commercial real estate

National office vacancy rate rises to 8.5%

Rise from 6.1 per over the past 12 months shows recovery still elusive, Avison Young's mid-year report says

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A survey of Canada's 11 largest cities shows the vacancy rate in the national office market has climbed to 8.5 per cent at mid-year 2009 from 6.1 per cent at mid-year 2008, real estate firm Avison Young reports.

The downtown and suburban markets both experienced increases in vacancy year over year, rising from 4.4 per cent to 6.9 per cent, and 8.0 per cent to 10.4 per cent in each respective category.

"The rise in Canada's national vacancy rate from 6.1 per cent to 8.5 per cent over the past 12 months has as much to do with fear and the unknown as it does with growth prospects and fundamentals," says Mark Rose, Avison Young's chairman and CEO.

"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."

However, Mr. Rose adds: "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 United States, 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.

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Apart from Mississauga (10.8 per cent) and Halifax (10 per cent), market-wide vacancy rates in Canada remain below the 10 per cent mark.

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

In contrast, the Western markets of Vancouver, Edmonton and Calgary witnessed declining office demand 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 per cent from 5.0 per cent one year ago. Edmonton, which has benefited greatly from an overheated Calgary market, saw its vacancy rate jump 220 basis points over the past year to 7.5 per cent currently. Calgary witnessed the most notable change in vacancy among the Western markets, rising 570 basis points to 9.3 per cent 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 basis points to close the first half of 2009 at 9.6 per cent – a three-year high. Montreal (8.6 per cent) and Quebec City (4.1 per cent) followed, with increases of 130 and 120 basis points, respectively. Finally, continued federal government demand kept vacancy in Ottawa (6.8 per cent), the country's capital, relatively in check, rising only 70 basis points between mid-year 2008 and mid-year 2009.

Canada's average downtown Class A net asking rents dipped from \$25 per square foot at mid-year 2008 to \$22 per square foot at mid-year 2009. On average, net asking rents for downtown Class A office buildings across Canada range from a low of \$13 per square foot in Quebec City to a high of \$30 per square foot 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 per square foot for downtown Class A and B space, respectively.

Mr. Rose adds: "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."

Regional Snapshot

Office markets in the major regions:

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 per cent at mid-year 2009 from 5.0 per cent 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 per cent at mid-year 2008 to 5.0 per cent at mid-year 2009 while the suburban vacancy rate bumped up to 9.1 per cent from 7.2 per cent at mid-year 2008."

Vacant sublease space in Metro Vancouver totalled 948,872 square feet at mid-year 2009 – triple the 304,395 square feet recorded at mid-year 2008.

The downtown core currently accounts for 460,158 square feet of the vacant sublease premises. Mr. 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."

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 per cent," comments Avison Young principal Todd Thronson in Calgary.

"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."

Mr. Thronson 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 per cent, 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 per cent, 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 square feet 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 per cent."

Regina

In contrast to most other regional markets, vacancy in the Regina office

market decreased to 2.3 per cent at mid-year 2009 from 2.4 per cent 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," says 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 per square foot."

Rents for existing Class A space currently range from \$19 to \$25 per square foot, while class B space leases for \$14 to \$17 per square foot. Class C premises hover in the \$10-per-square-foot range.

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.

"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 (million square feet), witnessed a net vacancy decrease of 0.1 per cent from the second quarter of 2008 to 4.7 per cent currently (or 113,400 square feet). The class B market, which encompasses 2.7 msf, experienced a 4.4 per cent increase in vacancy to 9.9 per cent, or 269,637 square feet, 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 square feet of Class A sublet space and an increase of 8,574 square feet 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 pre-leasing 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," Mr. Dockrill says.

Toronto

The economic headwinds 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 per cent. Not only is this a 300 basis points jump from one year earlier, it is also a level not seen in three years," Avison Young principal Mark Fieder says 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 basis points from one year ago to 7.6 per cent currently, it remains well below the recent peak of almost 12 per cent 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 per cent. These impending vacancies, along with 3.7 msf in the supply pipeline, of which almost 2 msf (69 per cent preleased) is scheduled to be completed over the next nine months, has created a tremendous window of opportunity for the occupier community," explains Mr. 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."

Mr. Fieder says this window is expected to remain open as vacancy/availability is poised to breach the 10 per cent 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 per cent – 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.

"Of note this year was Public Works and Government Services Canada's first foray into the Kanata submarket with 60,000 square feet. This was a welcome change in the struggling submarket, which still has in excess of 20 per cent vacancy."

Meanwhile, the sub-3 per cent vacancy rate in the core is one of the lowest in the country. Minto's 180 Kent Street project, with 380,000 square feet of new LEED gold standard construction, will open this year 80 per cent occupied.

Montreal

Aside from larger tenants looking for premises greater than 30,000 square feet, 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 per cent 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 per cent. 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 per cent, but experience positive growth of 2.9 per cent in 2010."

Quebec City

Forecasted economic growth for Quebec City in 2009 is 0.6 per cent, 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," Mr. Pellicelli says. "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 per cent at the end of 2009's second quarter from 3.0 per cent 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 per cent currently from 2.7 per cent at mid-year 2008. The city's average net asking rental rate has also increased over last year's rate by more than 5 per cent.

Halifax

While the Halifax economy has generally fared well compared with 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," says 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 square feet of convention space as well as retail and residential spaces."

Mr. 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.

- *With a report from Avison Young*

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