

What oil sands giveth, oil sands taketh away

Economic meltdown, drop in commodity prices cool Calgary's white-hot suburban market

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SPECIAL TO THE GLOBE AND MAIL
MARCH 31, 2009

A few months ago, Calgary leasing executive Sean McCullough didn't fret if a deal didn't come together. At the time, office vacancy rates were low, rents were high and real estate transactions, especially in the fast-growing suburbs, were easy to come by.

"If we didn't do a deal today, we knew we'd get one tomorrow," says Mr. McCullough, vice-president of leasing for Strategic Group, which owns and manages six million square feet of suburban and downtown office and retail buildings in Calgary and Edmonton.

But in a few short months, the global economic meltdown and attendant drop in commodity prices have turned Calgary's white-hot suburban office market on its heel.

Insiders say the cancellation, delay or cutback of oil sands projects has caused many tenants, particularly the large-scale engineering and oil sands servicing firms that have driven growth in the suburbs, to cut costs, and that has put large swaths of office space back on the market.

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Calgary's suburban office vacancy rate is now higher than that of other major cities, including Toronto and Vancouver, experts say. It has also risen faster than in some other places, the pros note.

For leasing agents such as Mr. McCullough, this has meant a steep drop in activity. Last year, Mr. McCullough estimates that more than 200 new leases flowed through his company, many of them on his suburban properties; he expects the total number to drop by half in 2009.

"Today, we can't afford to lose any business," he says.

While office deals have slowed in all of Calgary, brokers say the suburbs are feeling the crunch much more.

"They're always the first market to become challenging and the last to improve," says Todd Thronson, managing director of brokerage Avison Young Calgary Inc.

Office vacancy rates in Calgary's suburbs will hit 10 per cent by the end of 2009, predicts a recent Colliers International report. That's up from nearly 4.2 per cent in the first quarter of 2008 and 6.6 per cent in the fourth quarter of last year.

Downtown vacancy rates, meanwhile, have risen less drastically, from 3.3 per cent in the first quarter to 4.6 per cent in the fourth quarter of last year.

While the downtown market is also expected to soften further, experts don't believe the drop will be as big as in the suburbs. Moreover, they say, some areas of the suburbs, notably the city's Northeast quadrant, could see vacancy rates running up to 17 per cent by December.

"Statistically, that's a very high vacancy rate for our market," says Chris Law, vice-president of the Calgary office of Colliers International Property Consultants Inc.

The reason? A combination of suburban overbuilding and tenant downsizing, Mr. Law says.

Until a few years ago, Calgary's office market was concentrated over nine square blocks in the downtown. But a combination of dwindling space and skyrocketing demand, as well as high construction costs and exorbitant rents - up to \$45 a square foot in mid-2008 - began pushing both developers and tenants outward.

And the suburbs offered large blocks of land to develop, with rents going for just over half -about \$27 a square foot - of what downtown properties were commanding.

"Rising costs [downtown] pushed the issue and forced Calgary's suburbs to finally grow up," Mr. Law says.

And grow up they have. Since 2006, Mr. Law estimates as much as four million square feet of inventory have been added to the suburban market. Much of it was quickly snatched up by large-scale firms servicing the oil sands, brokers say.

But what the oil sands giveth, the oil sands taketh away. Sharp-pencilled tenants are looking for ways to cut costs, which means giving up space they don't need, Mr. Thronson says.

Subleases now constitute roughly a third of overall vacancy, Mr. Law estimates. "Tenants who took on large amounts of space in anticipation of growth are now unloading that space once again."

Brokers say engineering firms are leading the downsizing charge, shedding space as quickly as they are shedding jobs.

Nair Bailey, general manager of Calgary-based recruitment firm Bailey Professional Search, estimates that 3,000 engineering jobs have been cut in the city since December. "Many project teams that were hired for oil sands work have now been laid off," he says.

And fewer bodies in desks means less need for space, brokers say, noting that several engineering firms have, in the past few months, shed thousands of square feet of suburban office space.

Mr. Thronson warns that the worst is still ahead, when office buildings currently under construction are completed, putting even more space on the market. "There is a ton of suburban sublease space on the market right now, and a lot more coming."

This is bad news for the more undesirable office locations in the city, such as the Northeast quadrant, where "backfill" tenants will be especially hard to come by, Mr. Thronson says.

He estimates that there are a half-dozen properties in Calgary's Northeast quadrant each with more than 50,000 square feet vacant. "Even in a good year, the Northeast only ever sees a couple of deals that size take place."

On top of that, WestJet Airlines Ltd., a major Northeast tenant, will be putting another 150,000 square feet of space over six buildings on the market when it moves into a newly constructed 300,000-square-foot Northeast building near the airport this summer.

All this is making for a tough few years ahead, Mr. Thronson says. "We're in for a lot of pain."

But Calgary has seen its share of growing pains. After 20 years in the business, Mr. McCullough has seen the booms and busts come and go.

"It's nothing new - it's just something you have to work through," he says.

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Phillip Crawley, Publisher