Media Release

For Immediate Release (10 pages)
Wednesday, August 16, 2017

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Office sector undergoing important shift in dynamics as trends transform both demand and supply

Avison Young releases its Mid-Year 2017 North America and Europe Office Market Report

Toronto, ON — Amid varying economic performances and property fundamentals, North American and European office leasing markets are generally performing well as they undergo an important shift in dynamics influenced by trends transforming both occupier demand and the supply of new product. Traditional drivers of demand are being joined by emerging disruptors that will increasingly shape the future of the office-space market and commercial real estate as a whole.

These are some of the key trends noted in **Avison Young's *Mid-Year 2017 North America and Europe Office Market Report***, released today.

The report covers the office markets in 64 metropolitan regions in Canada, the U.S., Mexico, the United Kingdom, Germany and Romania: **Calgary**, **Edmonton**, **Halifax**, **Lethbridge**, **Montreal**, **Ottawa**, **Regina**, **Toronto**, **Vancouver**, **Waterloo Region**, **Winnipeg**, **Atlanta**, **Austin**, **Boston**, **Charleston**, **Charlotte**, **Chicago**, **Cleveland**, **Columbus, OH**; **Dallas**, **Denver**, **Detroit**, **Fairfield County**, **Fort Lauderdale**, **Greenville**, **Hartford**, **Houston**, **Indianapolis**, **Jacksonville**, **Las Vegas**, **Long Island**, **Los Angeles**, **Miami**, **Minneapolis**, **Nashville**, **New Jersey**, **New York**, **Oakland**, **Orange County**, **Orlando**, **Philadelphia**, **Phoenix**, **Pittsburgh**, **Raleigh-Durham**, **Reno**, **Sacramento**, **San Antonio**, **San Diego County**, **San Francisco**, **San Mateo**, **St. Louis, Tampa**, **Washington, DC**; **West Palm Beach, Westchester County, Mexico City**, **Coventry**, **London, U.K.**; **Berlin**, **Duesseldorf**, **Frankfurt**, **Hamburg**, **Munich** and **Bucharest**.

"The office sector and commercial real estate, in general, are not immune to the effects of globalization and technological innovation," comments **Mark E. Rose**, Chair and CEO of Avison Young. "The world is transitioning into a more distributed, automated and digital economy, which impacts how occupiers conduct business and think about their workplaces, and this transition may have profound implications on the role and intrinsic value of property. In turn, owners and developers are finding ways to adapt and provide flexible work environments that meet these changing requirements."

Rose continues: "Rapid change has given rise to the idea that technological advances could render physical real estate increasingly obsolete. However, historical evidence suggests that technology is just as likely to create new jobs as to displace them. For example, the likes of Amazon and WeWork are among the occupiers that feature most frequently in our report's survey of the largest lease transactions across Avison Young markets."

"Amazon's success in the digital realm is translating into increasing demand for physical space – not only in the retail arena, but also the industrial and, now, office sectors, pointing to a new driver of demand in the office market as the e-commerce industry continues to grow. Meanwhile, the growth of WeWork and other providers of co-working and space-sharing services demonstrates that business will still require physical workplaces, even as we move toward an interconnected world offering anywhere-anytime access to skills on demand."

Rose adds: "With Canada and the U.S. intertwined by close economic ties, the aforementioned disruptive trends continue to shape the Canadian and U.S. office markets, while in Mexico City, oversupply has led to the postponement of some new construction projects. Turning to Europe, the U.K. market is in flux one year on from the Brexit vote; Germany's markets are reporting strong performances with declining vacancy rates year-over-year; and in Romania, the newest country on the Avison Young map, solid results in Bucharest have been driven by the information-technology and communications sector."

According to the report, of the 64 office markets tracked by Avison Young in North America and Europe, which comprise almost 6 billion square feet (bsf), market-wide vacancy rates decreased in 40 of the markets as nearly 52 million square feet (msf) was absorbed on an annualized basis.

Occupiers' desire for new product remains strong and the development community has responded, as more than 62 msf of office space was completed during the 12-month period ending June 30, 2017. Meanwhile, another 134 msf was under construction at mid-year 2017 – with 50% of the space preleased.

CANADA

Trends prevalent in 2016 continued to play out in the first half of 2017 – and will likely shape Canada's office market in the foreseeable future as the sector adjusts to the changing dynamics.

"Evolving trends and varying fundamentals are challenging stakeholders to adapt more now than ever before – not just in Canada, but globally," states **Bill Argeropoulos**, Principal and Practice Leader, Research (Canada) for Avison Young. "On the Canadian front, the prevailing trends include urban intensification, transit-oriented development, consolidation, workplace design and millennials' live-work-play preferences."

Argeropoulos adds: "Though demand from traditional sectors has been patchy, technology and the co-working craze are transforming the marketplace, garnering an increasing share of the leasing pie. Co-working space providers have expanded rapidly due to the need to cater to startups, entrepreneurs and the increasing demand for affordable workplaces on flexible lease terms. Notably, U.S.-based WeWork has leased big blocks of space in Vancouver and Toronto after opening its first Canadian location in Montreal in 2016. Meanwhile, e-commerce is another ubiquitous driver, prompting firms such as Amazon (in Toronto) and home-grown Shopify (in Toronto and Ottawa) to grow their real estate footprints."

Argeropoulos concludes: "Traditionally having occupied funky, older premises or brick-and-beam product on the fringes of major urban cores, this sector is now seeking a larger presence in major towers, primarily in the country's downtown markets. These trends will challenge owners and occupiers to adapt to evolving circumstances and varying fundamentals in markets from coast to coast."

Notable Mid-Year 2017 Canadian Office Market Highlights:

- Canada recorded 12-month absorption of more than 3.7 msf. Losses in some western markets, largely in Calgary and Edmonton and, to a lesser extent, in Winnipeg, were offset by gains in Toronto, Montreal and Vancouver.

- Negative absorption in Calgary and Edmonton and new development in most markets raised the national office vacancy rate 70 basis points (bps) year-over-year to 12.1%; vacancy increased in five of 11 markets. Not surprisingly, Calgary had the highest vacancy (23.5%); Winnipeg once again had the lowest (6.6%), while Edmonton saw the biggest change (+530 bps to 17.2%).

- Due to disproportionate negative absorption and new supply, downtown markets posted an 11.3% vacancy rate at mid-year 2017 – up 160 bps in the past 12 months. Vacancy was higher in seven of 11 downtown markets; four remained in single digits, while six were below the national downtown average. Toronto's record low of 3.3% was the lowest downtown vacancy in Canada – and the lowest among major markets in North America.

- Owing to robust positive absorption (led by Toronto and Montreal), suburban markets combined for a 13.6% vacancy rate at the midway point of 2017 – marginally lower than at the same mark in 2016. Apart from Winnipeg (4%), double-digit vacancy prevails across Canada's suburban markets. However, vacancy declined in seven of 11 markets year-over-year, with five markets below the national suburban average.

- Developers added almost 10 msf of new office space in the past year, increasing Canada's inventory to more than 527 msf. Almost two-thirds of the supply was added to the nation's downtown markets. Exacerbating vacancy levels, Calgary saw the most deliveries overall and downtown, slightly ahead of Toronto.

- Undeterred by supply-demand imbalances across markets and taking a long-term view, developers had almost 13 msf under construction (48% preleased) at mid-year 2017 as downtown construction outpaced the suburbs by more than a two-to-one margin. Toronto had the most space under construction overall (6.4 msf) as well as the most downtown space (5.3 msf) being built, while Montreal had the most suburban space underway (1.3 msf). Year-over-year, Toronto saw the largest development pipeline increase (+1.8 msf), while the greatest decrease took place in Calgary (-3.9 msf) as the city's construction cycle draws to a close.

- Average downtown class A gross rents increased $0.52 per square foot (psf) year-over-year to $41.42 psf at mid-year 2017 – led by Vancouver ($53.50 psf) and Toronto ($49.16 psf). Regina ($39.50 psf) edged out Vancouver ($37.25 psf) to boast the highest suburban class A gross rents. Suburban class A gross rents jumped an average of $1.48 psf year-over-year.

U.S.

At mid-year 2017, the trends shaping the 5-bsf U.S. office market mirrored those found in Canada, including tenants displaying a distinct preference for transit-oriented development and the growth of co-working and flexible-office-space operators.

"Over the last 12 months, the U.S. economy continued to expand with job growth, dwindling unemployment averages and the stock market reaching record highs," states **Earl Webb**, Avison Young's President, U.S. Operations. "The office sector's performance reflects that growth even while there is little political clarity, and predictions for the rest of the year remain mixed. This year, we saw co-working and flexible spaces gain market share, and we are tracking their impact on office leasing conditions for owners and occupiers. Landlords are responding to these trends by retrofitting common areas to include tenant amenities and social-gathering spaces."

The report goes on to say that the preference for plug-and-play leasing options has contributed to the rise of speculative office suites in buildings' available vacancy. As well, suburban markets with a sense of place – walkable, accessible to transit and with amenity, entertainment or destination retail – are emerging as their own urban centers.

Webb continues: "Again this year, the office market has felt the effect of tenant right-sizing and the ongoing flight to quality, so it is not surprising that there was an overall fall-off in downtown net absorption. In spite of some markets remaining oversupplied, tenant demand for quality space is fueling the need for new construction. As of July, there was 91 msf underway in the U.S., and while that space is more than half preleased, it is likely that vacancy will increase in the markets where development is concentrated. Still, several markets that were of concern in 2016, such as Houston, continued to stabilize during the past 12 months."

Notable Mid-Year 2017 U.S. Office Market Highlights:

- Seventeen markets represented 77% of the 5-bsf U.S. office inventory. Eleven of those had lower vacancy rates at mid-year 2017 compared with the same point in 2016.

- Although overall U.S. vacancy remained the same at 12.2% year-over-year, the disparity in market performance between the suburbs and downtowns is clearly evident in net absorption. The suburbs finished the 12-month period ending mid-year 2017 with 30.5 msf of absorption, compared with 33.4 msf one year earlier. Conversely, 2.4 msf of occupancy was lost in the downtown markets compared with 13.6 msf of positive absorption in the prior 12-month period.

- At mid-year 2017, the downtown markets had 43.4 msf under construction (49% preleased), and the suburban markets had 47.7 msf under construction (61% preleased). Taken together, projects under construction were 55% preleased at mid-year 2017.

- Of the 91 msf underway in the U.S., 47% is in five markets: Washington, DC (12.7 msf), Dallas (9.9 msf), New York (9.4 msf), Los Angeles (5.7 msf) and San Francisco (5.6 msf).

- Of the major markets, Houston had one of the country's highest mid-year 2017 total vacancy rates (16.8%), yet continues to stabilize. Its recovery is hampered by a glut of sublease space and tenants giving space back, keeping market conditions softer, longer. Meanwhile, Dallas, where vacancy remains above 14%, had 4.7 msf of absorption (the highest in the country) and enjoyed corporate expansion and build-to-suit construction activity.

- Among the downtown markets, New York again led the country in class A average asking gross rent at mid-year 2017 ($83.77 psf), with six other markets (San Mateo, San Francisco, Boston, Washington, DC; Austin and Fairfield County) also exceeding the national average of $53.94 psf.

- In suburban markets, the national class A average asking gross rent was $30.88 psf at mid-year 2017. Notably, when the top seven downtown markets were excluded, the delta between suburban class A and downtown class A national average rent was reduced to 10%.

"Flight to quality and tenant demand for efficient, amenity-rich options are trends that will carry the U.S. office market into 2018," concludes Webb. "Look for new construction to result in rising average asking rents in the increasingly competitive class A market and for vacancy to tick higher in the cities where development is occurring."

Please turn to the following pages of the report for highlights in the local markets. For further info/comment, please contact the Avison Young representatives listed below. Thank you.

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