CHANGE, CHANGE AND MORE CHANGE TO HIGHLIGHT COMMERCIAL REAL ESTATE IN 2015

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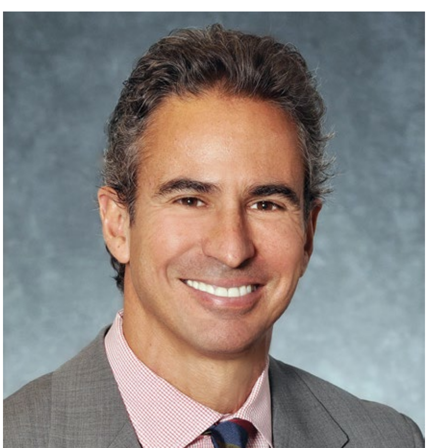

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It is said that change is the only constant in today's world, and looking at Canada's commercial real estate market that adage seems more appropriate than ever. Changing spending habits, commuting patterns, the emergence of the tech-savvy Millennial cohort, an explosion of downtown condo development, and interest rates so low that money is bordering on free, are changing everything we in the real estate world have taken for granted with recent events suggesting this is just the beginning.

Leasing and investment

Commercial real estate is primarily about two things: leasing and investment. The two are inextricably linked, with one dictating the other and vice-versa. Leasing markets across Canada have generally had a good run over the past several years, coming out of the global financial crisis and continuing into 2014, but cracks are beginning to appear. We have an office development wave that is destined to deliver 20 million square feet of predominantly downtown space at a time when occupiers are shrinking their footprint, when and where they can, and a natural-resource-based economy that no longer has the tailwind provided by the commodity super cycle that somewhat abruptly ended at the end of 2013. The recent drop in oil (and natural gas) prices is just the icing on the cake, so to speak. To an extent, technology tenants have come to the rescue, although their preferences for office space can be described as eclectic, with no clear winners on the landlord side in terms of location or building type – new, old, high-rise or low-rise. It is all very confusing and making a sweeping comment is all but impossible. As we get further into the year, with the shakeout occurring in many of the commodity-based markets, we will get a better sense of what impact a slightly less robust economy and a more tepid labour market will have on leasing markets.

Retail

Like office, retail is going through considerable change, most notably the arrival, and now departure of Target. Target was supposed to form the basis of a new junior department store that could act as a critical anchor for many of Canada's smaller centres. Alas, that will not happen and it has put into question the viability of many centres, particularly in smaller markets outside Canada's major metros.

Other new entries to the Canadian market are Nordstrom, soon to be followed by Saks Fifth Avenue, all this change just on the anchor side. New anchors always have the potential to be game changers, but, on top of this, online retail, or e-commerce, continues to be a very disruptive force as all retailers are forced to adopt the 'omni-channel' approach to meeting their customers' needs and wants. This is forming an interesting interchange between retail and industrial.

Retail has long been characterized by low vacancies, and, with the disappearance of Target, vacancies are destined to climb higher, but not to the extent that fundamentals will change in a material way; the underlying theme in retail is that it is not 'business as usual.' Retailers and landlords know this, and are looking for new and innovative ways of keeping foot traffic high and sales climbing. It is a very competitive landscape that will only become more so in the coming years.

Industrial

Canada's industrial market, at 1.7 billion square feet, does not move quickly, but even in this usually staid asset class, change is occurring. Users want more from their space, and, as a result, advancements in stacking, cross-dock facilities, and automation, as well as US-style 'fulfillment centres' are beginning to make their arrival, even if they are scaled down relative to what can be found south of the border. Canada's retailers, and in particular the large grocers, have been investing heavily in new distribution centres (DCs), in anticipation of what they thought would be new competition from Target, but also WalMart, which continues to expand with its large store supercentre format including groceries. New generation DCs are not just unique to the grocery chains, but across all retail segments. Supply chain management has become the new battleground for retailers. Blame a whole host of factors, but technology is right up there. Demand for warehouse space is generally strong, but for now, most demand is coming from the big users. This is supported by new development, where over 80% of warehouse space under construction is considered 'big bay' of at least 100,000 square feet.

Investment

Where does all this change leave the investment market? Investors still seem unshaken from their diehard belief that Canadian real estate is a great place to be and capital remains readily available. Investment volumes remain high, at least by historic standards, although the last 12 months or so have been characterized by very few large trophy-like trades and instead by more mid-priced properties sub-$25 million. Partial interest transactions, particularly for $50-million+ assets, are now almost more the rule than the exception. Land transactions, often with residential in mind, look set to remain a key part of the market, and speak to the merging of the commercial and residential markets with the accompanying valuation challenges.

Pricing

That takes us to pricing. Across the quality spectrum, across all property types and in virtually every part of the country, pricing remains elevated. With the uncertainty created by the recent drop in oil prices, there is an element of uncertainty that was not there previously. Now, record low interest rates are providing a nice buffer, and assuming oil prices find a floor near the $50/60 per barrel level, cap rates could even trend lower. The investment market is still characterized by the usual mix of institutional, public and private capital, but with the recent drop in the Canadian dollar, albeit mostly against the US dollar, the prospect of a surge of American capital is not out of the question.

So much change indeed. Canada's commercial real estate market is still the envy of most global markets, but without doubt a chapter has finished and a new one is about to begin. Think change – everywhere and for everything, including boring old real estate.