Real Estate / National Office Market Report

Toronto Fall/Winter 2010

Newmark Knight Frank

Devencore

Spotlight on the Greater Toronto Area

- New building inventory in Downtown District being leased at accelerated rate
- Tenants examining strategies to use space more efficiently
- Urban housing boom should support long-term stability and growth of downtown office market
- Leasing activity weaker in suburban submarkets

Space Absorption Accelerates as Canadian Economy Recovers Strength

Despite months of significant uncertainty in its business and financial communities, Canada's economy fared substantially better than most through the global financial crisis in 2008 and 2009. Even so, the national unemployment rate rose above 8.5%, real gross domestic product (GDP) contracted, and office vacancy rates increased in all of the country's major urban centres.

Through the first half of 2010 the Canadian economy began to regain its stability. Indeed, most indicators point to an economy that is in recovery mode. According to Statistics Canada, GDP increased by approximately 5.1% in Q1 2010, and by 2.0% in the second quarter of the year. While this growth—particularly in Q2—did not quite meet the expectations of the country's central bank, it nevertheless represents a GDP output that is only 0.1% below the peak recorded before the global financial crisis took hold. Additionally, Manpower Canada issued a report in early September that suggests the job market in the final months of 2010 should be healthier than its has been in almost two years.

The overall vacancy rate in Class "A" and Class "B" buildings in Canada's major cities—including Toronto, Montreal, Vancouver, Calgary, Edmonton, Winnipeg and Halifax—stood at 7.1% at the end of Q2 2010, up approximately 1.0% from mid-2009. It should be noted, however, that the total inventory of Class "A "and Class "B" office space increased by nearly 6.5 million square feet, or approximately 3%, over the same period. Much of this new inventory came onto the market in Toronto and Calgary, where significant development projects were well underway when the recession hit.

NKF Devencore anticipates that the positive space absorption that has taken place over the past year should accelerate in the months ahead as companies consider implementing certain expansion programs that were deferred in 2008 and 2009.

National Vacancy / Canada

Class "A" & "B" Office Area

Q2 2007	Q2 2008	Q2 2009	Q2 2010
4.41%	3.86%	6.12%	7.14%

Class "A" Vacancy Rates

	Q4 2008	Q2 2009	Q4 2009	Q2 2010
Halifax	3.6%	6.6%	4.6%	6.9%
Montreal	4.6%	7.2%	7.6%	8.0%
Ottawa	1.1%	1.6%	3.1%	4.1%
Toronto	4.3%	6.3%	8.2%	6.9%
Winnipeg	6.8%	6.3%	14.8%	14.0%
Edmonton	4.5%	4.5%	6.9%	8.6%
Calgary	1.8%	4.2%	6.4%	8.0%
Vancouver	4.0%	4.9%	3.6%	4.2%

Asking Rates-Downtown District

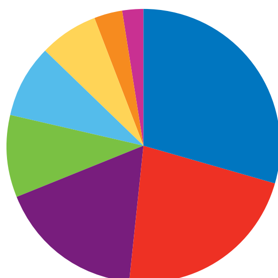
Estimated gross: includes estimated asking face rate + total real estate taxes, operating expenses and in-suite power (Average $ per SF)

Class "A"

	Q2 2007	Q2 2008	Q2 2009	Q2 2010
Halifax	$30.42	$31.22	$32.83	$32.87
Montreal	$36.66	$38.45	$38.57	$38.42
Ottawa	$43.95	$45.61	$45.62	$45.82
Toronto	$50.22	$51.95	$50.58	$43.68
Winnipeg	$29.12	$29.47	$29.55	$28.69
Edmonton	$35.41	$41.03	$42.61	$40.31
Calgary	$48.47	$51.55	$52.70	$54.65
Vancouver	$47.95	$55.24	$58.85	$50.94

Class "B"

	Q2 2007	Q2 2008	Q2 2009	Q2 2010
Halifax	$23.37	$24.12	$23.94	$25.36
Montreal	$26.18	$27.00	$27.75	$28.06
Ottawa	$32.82	$33.36	$33.34	$33.18
Toronto	$34.30	$36.35	$37.06	$34.86
Winnipeg	$23.15	$23.44	$23.17	$23.78
Edmonton	$19.71	$24.33	$31.26	$33.27
Calgary	$47.12	$49.41	$49.34	$42.37
Vancouver	$35.25	$40.60	$43.46	$39.64



Office Space Distribution in Canada's Major Cities

Class "A" & "B" Combined

	Q2 2010	Total Office Area (sq. ft.)
Toronto	29.58%	61,037,936
Montreal	22.32%	46,055,162
Calgary	17.11%	35,299,615
Vancouver	9.72%	20,063,939
Ottawa	8.65%	17,843,860
Edmonton	6.85%	14,137,321
Winnipeg	3.43%	7,073,040
Halifax	2.33%	4,803,808

Flight to Quality Characterizes GTA Corporate Real Estate Market

Newmark Knight Frank
Devencore

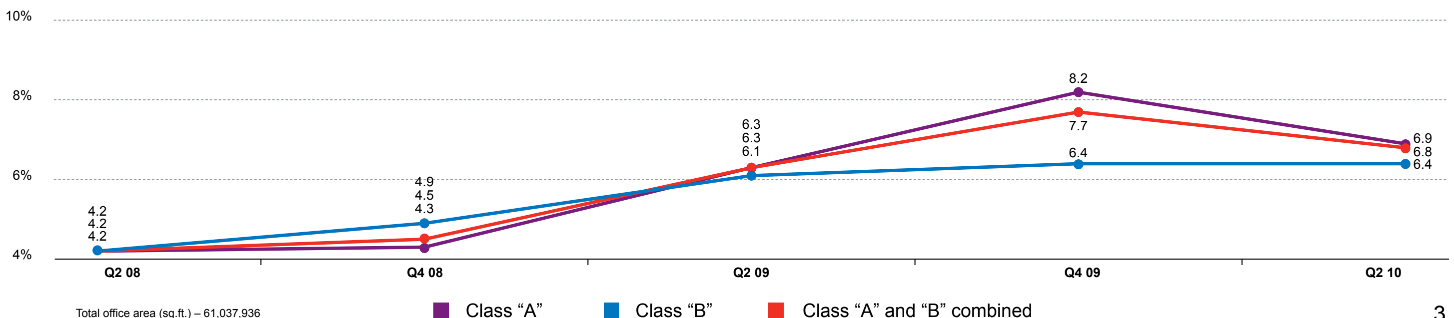
Market Overview

As 2010 moved past the midpoint, it became increasingly evident that the Toronto corporate real estate market, particularly in the Downtown District, was enjoying a resurgence. The Greater Toronto Area (GTA) economy continued to show signs that it was emerging from the recession, and the economic outlook for the rest of 2010 has been decidedly positive. Indeed, the Conference Board of Canada sees Toronto leading all Canadian cities in terms of growth, forecasting a real GDP of 4.7% for the year, compared to 3.6% growth in the country as a whole. In the same study published in September, the Conference Board of Canada also noted that, in most of the country, employment was on the rise, financing rates were low, equity markets were regaining strength and consumer confidence was relatively strong.

Other encouraging signs of recovery include the level of activity that has been taking place in the Downtown Toronto's office leasing market. Downtown Toronto—including the Financial Core—has the largest inventory of Class “A” and Class “B” office space in Canada, comprising approximately 61 million square feet. Of that total, over 3 million square feet has been delivered over the last 12-18 months. What is remarkable about this new space is that tenants have been quick to snap it up, a phenomenon that has come to be known as a “flight to quality.” In fact, the extent of the current demand for this new breed of office space is significant enough to raise the possibility of more new office development in the near future.

Outside of the city core leasing activity has been relatively stagnant over the past six months. It will likely take some time before these corridors see occupancy rates return to pre-recession levels.

Toronto Downtown District Office Vacancy Rates



Downtown District

The inventory of approximately 61 million square feet of Class “A” and Class “B” office space that Newmark Knight Frank Devencore tracks in Toronto’s Downtown District is distributed among 275 buildings. At the end of 2007, the combined vacancy rate in this office space had plunged to 3.9%, an historic low. By the end of 2009, however, the combined vacancy rate had jumped to 7.7%, largely because of the influx of new space.

Thus far in 2010 the market has been active. The combined vacancy rate has decreased to 6.8%, leaving 4.1 million square feet of space vacant. Once one takes into account the nearly 886,000 square feet of new inventory that came on stream over the first two quarters of 2010, approximately 1.4 million square feet has been absorbed, which outstrips even the more optimistic predictions that real estate analysts made at the beginning of this year.

Much of this growth has come from the financial and professional sectors. As well, the pent-up demand for space that existed before the onset of the recession is now beginning to be addressed and corporate expansion plans are once again being implemented.

The new towers that have been the focus of much leasing activity address some critical tenant priorities. The buildings offer a number of sought-after amenities, from abundant natural light and efficient space layouts to contemporary building systems that allow tenants and their employees a great deal of control over their office environments. Tenants are discovering that these buildings can play a key role in attracting and retaining the best employee talent.

As tenants migrate to the new buildings, the older Class “A” office space that is being freed up will offer some very good leasing opportunities. Landlords will be trying to attract traditional Class “B” tenants into the older Class “A” space, much of which is being upgraded to more contemporary standards. Some landlords are also now willing to consider lease takeovers, although the terms they are presently offering may not necessarily make it feasible for tenants to relocate. Finally, as we noted six months ago, significant blocks of vacant space and the associated aggressive pricing are building-specific. Landlords still have considerable negotiating leverage in the more fully-occupied, top-tier buildings.

Financial Core

Newmark Knight Frank Devencore currently tracks 94 Class “A” and Class “B” buildings in the Financial Core. They offer a total inventory of approximately 31.9 million square feet, 25.9 million in Class “A” buildings and 6 million in Class “B” buildings. Between December 2009 and mid-2010 the combined vacancy rate in these properties fell from 8.6% to 6.7%. This decrease represents the positive absorption of over 760,000 square feet of space.

As noted, the new Class “A” towers that have come onto the market over the past two years have attracted a great deal of tenant interest. The Bay Adelaide Centre, a 1.2-million-square-foot office tower that opened in September 2009, has KPMG as its anchor tenant; with Heenan Blaikie's recent 12,000 square-foot expansion, the occupancy rate is now approximately 85%. The 750,000-square-foot Telus building, which came on stream this year, has a 90% occupancy rate. Finally, the 650,000-square-foot development at 18 York Street has PricewaterhouseCoopers as its lead tenant and has reportedly secured RSA as its second major tenant. The expected completion date for this tower is September 2011.

The leasing activities of the financial and professional firms that currently account for much of the growth in Toronto’s downtown have begun to push out the boundaries of the Financial Core. Traditionally defined by Queen and Front streets to the north and south and Yonge and University to the east and west, respectively, the Financial Core is effectively expanding southward to Lakeshore Boulevard and west as far as Simcoe Street. The 41-storey RBC Centre, for example, which opened in June 2009, has an occupancy rate of over 90% with the recent signing of Davies Ward Phillips & Vineberg to a 100,000 square-foot lease.

The flight to state-of-the-art Class “A” product will see vacancy rates at unusually high levels in older Class “A” buildings such as Commerce Court West at 199 Bay Street, First Canadian Place, and the Royal Trust Tower at 77 King Street West. Average asking rental rates have dropped in the Financial Core over the past 18 months, although these rate decreases are not consistent across the board. Tenants that carefully research the full range of market opportunities will secure the best deals.

Other Corridors

In the business corridors outside Toronto's Downtown District, the office markets have seen varying levels of transactional activity over the past six months. In the Midtown-Bloor area there has been moderate tenant movement, with combined Class “A” and Class “B” vacancy rates falling from 6.8% to 6.0%. Most of the absorption has occurred in the Class “A” segment, where just under 100,000 square feet was leased. At present, approximately 200,000 square feet is vacant in this corridor.

Overall vacancy rates also declined in the North Yonge area, from 9.2% to 7.4%. Once again the Class “A” market segment was most active, with vacancy rates decreasing from 10.7% to 8.8%, a positive absorption of over 115,000 square feet. Vacancy rates in the smaller Class “B” market also dropped considerably, from 4.8% to 2.9%, and office space in this submarket is very scarce—a total of just over 60,000 square feet is available.

Conversely, vacancy rates in the East-Highway 404 and Highway 7 corridor have increased from 11.2% to 14.4%. At present, over 1.2 million square feet stand vacant, so tenants should be able to identify a range of very good opportunities here.

Finally, in the West-Airport Corporate Centre corridor vacancy rates will reach the 24% range with the delivery of the AeroCentre V project, a LEED Silver building offering 225,000 square feet over five levels.

In the corridors with substantial vacancies, landlords may be more flexible in leasing negotiations, particularly with those tenants who are willing to commit to long-term leases.

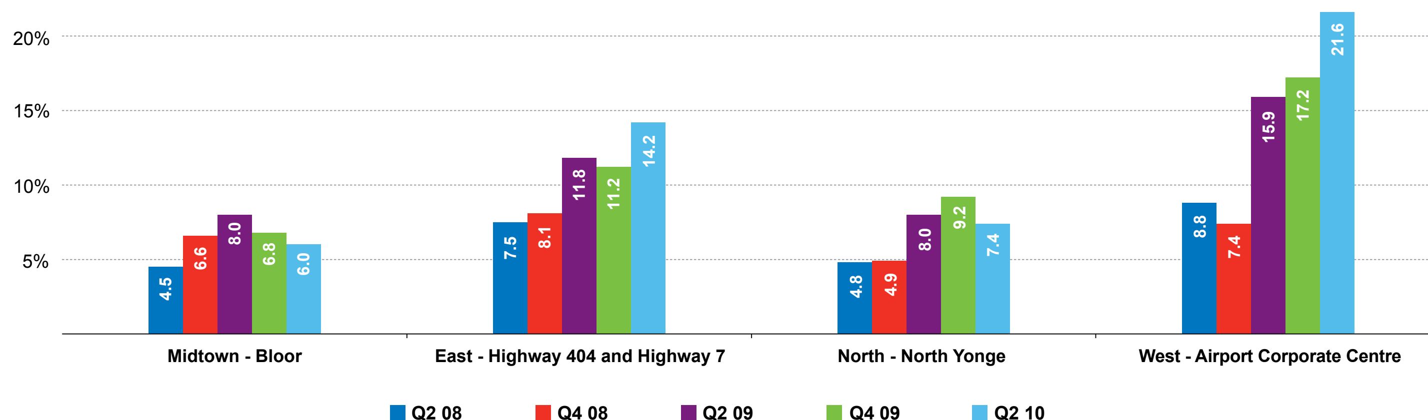
Trends: Efficient Space Utilization

As tenants grow more comfortable with treating their real estate portfolios strategically, they are taking a harder look at how they might best manage those portfolios to help regulate operating costs, of which occupancy expenses represent a significant portion.

The drive for more efficient space utilization raises a number of considerations, including the relative merits of open vs. closed office concepts, evolving workplace standards and the suitability of other alternative workplace strategies such as hoteling, flex space and home offices. Employers are also becoming increasingly sensitized to the importance of assessing the work environment as key component in attracting and retaining employees.

Further, the cost per square foot of office space is only one part of the operating budget equation. In order to save money, an organization also needs to save space. Increasingly, we are seeing a greater number of tenants making a concerted effort to reduce occupancy space per employee by as much as 10%, while continuing to provide an environment that can enhance employee productivity and quality of life. It is generally easier to reduce square footage per employee when moving into new premises than to redesign existing space. Making the right strategic decisions can boost workplace efficiency and make a substantial impact on the bottom line.

Toronto Business Corridors, Vacancy Rates, Office Space
Class “A” and “B” Combined



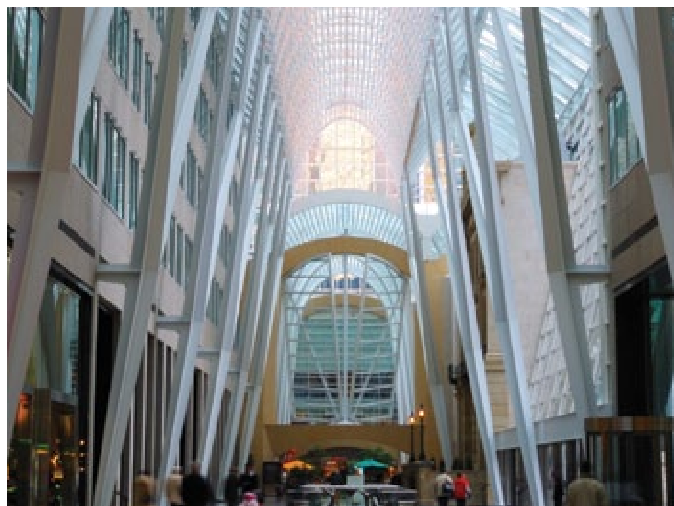
Spotlight: Urban Housing Development Vitalizing Downtown Office Market

Over the past decade, the Toronto downtown skyline has been transformed by a boom in condominium construction—by some estimates the city is home to North America's biggest condo market. One of the drivers of this boom has been Toronto's consistent ranking as one of the world's most livable cities by such international organizations as the Economist Intelligence Unit and the Mercer consulting group.

Another factor has been the influx of suburbanites escaping long commute times and less-than-adequate transportation infrastructures in some of the GTA's suburban communities. And while the majority of condo buyers were once of retirement age, condo-dwellers today are largely young professionals.

As more and more of this skilled workforce moves into Toronto, there is an increasing competitive advantage for employers who wish to attract and retain the best and the brightest to locate their organizations downtown as well. Indeed, we are seeing corporations that may once have targeted lower-cost suburban office parks now seriously considering office space in close proximity to the young professionals and families who have made Toronto their permanent home and who want workplaces they can virtually walk to.

As a result, and contrary to the pundits who believe that downtowns will become relics of the past, we feel that Toronto's downtown office market will be stable over the long term and will continue to expand, driven by corporate tenant and employee demand and supported by blue-chip landlords.



Addressing Tenant Needs

Since real estate decision-making in the 21st century is a multidimensional and multifaceted process, in which building technologies, workplace environments, human resources priorities, portfolio strategies as well as rents and locations must be considered, tenants now routinely require a greater range of services and expertise from their advisors. Newmark Knight Frank Devencore has always endeavoured to lead the way in providing these personalized services to its corporate clients, and in order to further augment our expertise we recently welcomed Peter Icely to our Toronto office as Executive Vice-President and Managing Director, Corporate Services. Mr. Icely has Fortune 500 experience in all aspects of corporate real estate in Canadian and U.S. Markets and in both end-user and service-provider organizations. We are pleased to be able to provide his considerable expertise to those tenants who are embarking on a strategic analysis of their real estate requirements.

Outlook

The resurgence of Toronto's Downtown District and Financial Core through the first half of 2010 should continue through the rest of the year. Since office space in the new towers is being leased up quite quickly, the older Class “A” stock that has been vacated should offer an attractive range of leasing options to tenants that may traditionally have sought out Class “B” office space. The best opportunities will likely be found only in a limited range of buildings with low occupancy levels, however, so tenants are best advised to strike deals while this situation exists.

While average asking rents have decreased over the past two years, the increase in demand should see these rates begin to climb again in the not-too-distant future. Those Downtown tenants with leases coming up for renewal over the next 12-24 months should begin their real estate process as soon as possible. In the suburban areas there remains a relative abundance of vacant inventory, so asking rental rates in these markets will likely remain soft over the short term.

Toronto's corporate real estate market is once again entering a very dynamic phase. As the GTA's most active broker representing tenant interests exclusively, Devencore will be monitoring any market shifts very carefully in the months ahead in order advise our clients of new opportunities as they arise.

Newmark Knight Frank Devencore

Many businesses across the country are starting to grow again. Quality space is being absorbed and the new inventory that has come on stream over the past couple of years is proving to be especially attractive. Through the rest of 2010 and in 2011, we anticipate positive space absorption in most Canadian cities.

In **Halifax**, combined Class “A” and Class “B” vacancy rates rose through the first half of 2010, from 4.5% to 6.3%, but this increase reflects the addition of approximately 70,000 square feet of inventory to the market.

Quebec City's vacancy rates are currently tracking in the 5.5% range in the downtown area and the local economy appears to be strengthening. More than 1 million square feet of new space came onto the market in 2009, so there are still good opportunities for tenants.

In **Montreal**, vacancy rates began to stabilize through the first six months of 2010 and settled in the 8.0% range. There are indications that the strong demand for space that existed just over two years ago is once again being revived, and for the remainder of 2010 and into 2011 there will likely be increasing activity in the downtown core's office leasing market and a corresponding drop in the amount of vacant space.

Ottawa’s downtown vacancy rates continue to be the lowest in the country, tracking at 3.4%. However, the region's hi-tech centres, Kanata and Ottawa West, were severely impacted during the recession. At present, space is slowly being re-absorbed and the overall vacancy rate has fallen from 19.5% to 16.4%.

Winnipeg’s combined Class “A” and Class “B” vacancy rate rose from 7.2% to 11.1% over the past year, in part because of the addition of over 415,000 square feet of office space to the city's Class “A” inventory, as well as Manitoba Hydro's new 656,000-square-foot headquarters.

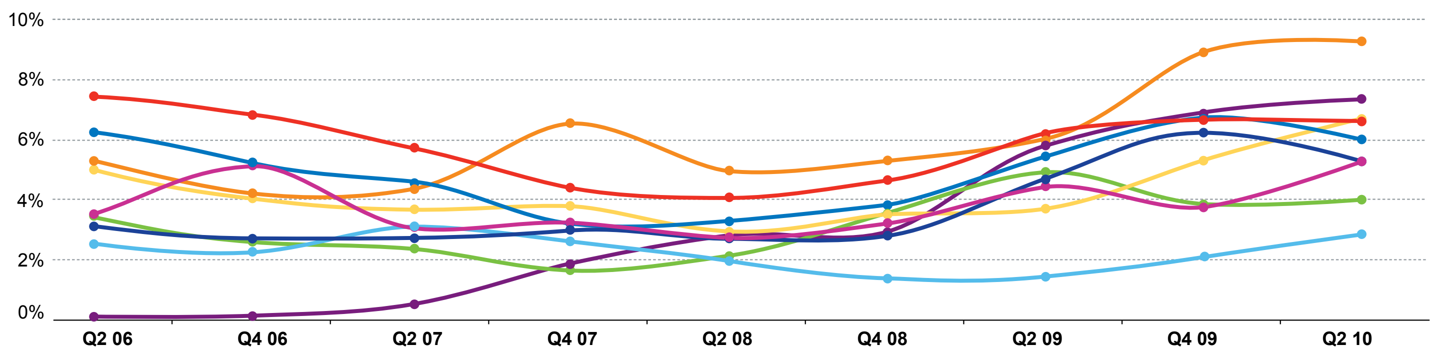
In **Calgary**, downtown office occupancy rates approached 100% just a few years ago. Then, commodity prices plummeted in the economic crisis and new office inventory began to arrive on the market. Consequently, vacancy rates have climbed steadily and now stand at 8.8%. Vacancy rates may continue to edge upwards with more new product being delivered.

Edmonton's overall vacancy rate jumped from 4.4% to 7.9% over the past year. The delivery of new office space accounts for some of this increase. Landlords are currently offering a greater range of incentives to attract and retain corporate tenants.

Vancouver’s downtown vacancy rate has actually fallen over the past 12 months, from 5.9% to 4.8%. The absence of any new development will make this a very tight market for the foreseeable future. For tenants, the suburban markets continue to offer a much greater range of leasing opportunities.

Downtown District Vacancy Rates Comparison, Office Space

Class “A” and “B” Combined



Total Office Area (sq. ft.) Q2 10

Halifax	Quebec City	Montreal	Ottawa	Toronto	Winnipeg	Calgary	Edmonton	Vancouver
4,803,808	17,247,911	46,055,162	17,843,860	61,037,936	7,073,040	35,299,615	14,137,321	20,063,939

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New statistical criteria

Since July 2004, new criteria are being used to establish Devencore's statistical data. Therefore, any data in both this report and future market studies should be compared with caution when referring to previous publications. We include buildings that are not part of the competitive leasing market—for example, certain institutional buildings that are fully owner-occupied, and exclude lower-quality properties lacking the general appeal to office market trends. Class "A" and Class "B" are definitions used to classify competing buildings on the basis of amenities, location, age, building technology, space efficiency, tenant appeal and other qualities that determine competitive rank and achievable rents. As used in the real estate industry, Class "A" refers to the group of free-standing office properties (generally built and/or renovated after 1990) that were designed to deliver first-class occupancy standards at strategic business locations. The Class "B" group largely includes older buildings that were leaders in their day, and which have now been surpassed by newer buildings.

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