nyrej

Avison Young releases 2015 commercial real estate forecast for Canada, U.S. and U.K.

January 26, 2015 - Front Section

After enjoying better-than-expected GDP growth in the third quarter of 2014 and an unemployment rate in late 2014 that flirted with pre-recession levels, Canada's sound commercial real estate sector will face headwinds in 2015. A weakening global economy, sliding oil prices, a burgeoning development pipeline and a possible U.S. Federal Reserve-led interest-rate hike will create both risk and opportunity.

Following a year of widespread occupier demand, rising employment and improved real estate fundamentals, the U.S. economy expanded further in 2014 with business investment bolstering economic progress. Though the recent drop in oil prices could hurt energy-driven markets, most U.S. cities are forecasting further progress in 2015. Meanwhile, across the Atlantic, London's position as a "world city" has insulated it from the poor economic environment in continental Europe.

These are some of the key trends noted in Avison Young's 2015 Canada, U.S. and U.K. Forecast.

The annual report covers the office, retail, industrial and investment markets in 46 Canadian, U.S. and U.K. metropolitan regions: Calgary, Edmonton, Guelph (Southwestern Ontario), Halifax, Lethbridge, Mississauga, Montreal, Ottawa, Quebec City, Regina, Toronto, Vancouver, Winnipeg, Atlanta, Austin, Boston, Charleston, Chicago, Cleveland, Columbia, Columbus, OH; Dallas, Denver, Detroit, Fairfield County, Greenville, Houston, Las Vegas, Long Island, Los Angeles, New Jersey, New York, Oakland, Orange County, Philadelphia, Pittsburgh, Raleigh-Durham, Reno, Sacramento, San Diego County, San Francisco, San Mateo, South Florida, Tampa, Washington, DC; and London, U.K.

"Most of the developed world is currently operating in a very positive 'Goldilocks' environment - with liquidity strong and transactional volumes at high levels, property and employment fundamentals improving, and alternative investment choices offering lower or more volatile yields. These background conditions suggest that now is the optimal time to pause and assess where you might be able to balance risk, take profits and redeploy resources to exploit future market opportunities," comments Mark E. Rose, Chair and CEO of Avison Young.

He continues: "Whether you are a tenant, owner, investor or lender, we see four factors that warrant serious reflection in a top-down view of your commercial real estate assets and that will ultimately shape winners and losers in the year ahead:

* Long-term level of demand for real estate as a core or alternative investment and associated allocation shifts;
* The obsolescence of certain types of real estate as the pace of technology adoption increases;
* Shifting operational and locational considerations driven by changing demographics, urbanization and transit; and
* Shifts in global monetary policy decisions, commodity pricing, interest rates and inflation."

"When you combine the impact of interest-rate changes with volatile oil and other commodity prices, demographic shifts, technological developments, anticipated and unanticipated government intervention and rising global conflicts and terrorism, you get uncertainty - and, accordingly, opportunity - at every turn."

According to Avison Young's 60-page report, of the 45 office markets tracked across North America, 25 markets saw office vacancy rates decline during 2014, with an overwhelming majority of U.S. markets seeing an improvement as vacancy increased in almost all Canadian markets.

The Canadian office market collectively reported a vacancy rate of 9.4% in the closing months of 2014, compared with 13.6% in the U.S., as the spread in office vacancy between the two countries narrowed to 420 basis points (bps) from 560 bps in 2013. The onset of new supply will narrow the gap further in 2015 with office vacancy in Canada forecasted to rise gradually to 9.8%, while the U.S. rate is expected to retreat to 13.2%.

Industrial vacancy rates in each country are roughly half of office vacancy rates. The report shows Canada's industrial vacancy rate settling at 4.2% as 2014 drew to a close, while the U.S. industrial vacancy rate was 300 bps higher at 7.2%. The gap between the two countries will likely narrow to 260 bps by year-end 2015, as vacancy is projected to edge slightly higher in Canada (4.6%), while holding steady in the U.S. (7.2%).

CANADA

"Demographics, technology and increasing space-planning efficiency are transforming Canada's office markets, leading to a renewal of major downtown stock by means of new development or redevelopment, while e-commerce and omni-channel strategies are blending warehouse/logistics and retail," comments Bill Argeropoulos, Principal, Practice Leader, Research (Canada) for Avison Young. "Undeterred by supply-demand imbalances, developers are taking a long-term view, with more than 22 million square feet (msf) of office and 16 msf of industrial product currently under construction across Canada."

Argeropoulos continues: "Buzzwords such as omni-channel, bricks-and-clicks, endless aisle, showrooming, webrooming and shoppertainment, to name a few, are expanding the retail lexicon as the marketplace continues to evolve. Looking ahead in the retail sector, marketing budgets are expected to increase as stakeholders invest in physical and digital assets, as well as new concepts, and measure consumer habits, fuelling the 'Big Data' phenomenon."

"In the industrial market, growing demand from the U.S. and a weaker Canadian dollar will benefit the export sector, but declining oil prices and volatility in global energy demand could put pressure on resource-based Western Canadian markets, many of which currently boast double-digit rental rates and slightly lower vacancy levels versus the manufacturing-laden markets in the East."

"Finally, on the investment front, while pricing has come off slightly for non-core assets in secondary markets, the urgency to place capital in well-leased, core assets - by domestic as well as foreign players - has pushed pricing higher and cap rates lower in some cases. Despite institutional investors' hold on domestic real estate assets, foreign capital continues to find its way in, and some buyers are paying a premium for entry, underscoring Canada's image as a safe investment bet."

Argeropoulos points to a pair of notable foreign investment deals in 2014: the $300-million sale of an 840,000-sf, five-office building Bell Canada campus on Nun's Island in Montreal to a consortium of South Korean investors; and the Spanish billionaire owner of Zara's purchase of

150 Bloor Street West, an office building in Toronto's posh Bloor Street shopping district, for $255 million.

Notable report highlights include:

Office

* Canada's office vacancy rate increased 90 bps from year-end 2013 to close 2014 at 9.4%. Vacancy climbed in 11 of 13 markets surveyed, with increases of 30 to 400 bps. Vacancy is forecasted to rise modestly to 9.8% by year-end 2015.
* Eight of 13 markets posted single-digit vacancy rates in 2014 versus 11 in 2013, with six of the 13 markets recording rates below the national average.
* Collectively, Western office markets saw an 80-bps rise in office vacancy, averaging 8.8% at year-end 2014, compared with a 100-bps jump in Eastern markets, which ended 2014 at 9.8%. The West-East divide will widen from 80 bps in 2013 and 100 bps in 2014 to 180 bps by year-end 2015.
* More than 22 msf of office space is under construction across Canada (55% preleased and representing 4.3% of existing stock) - with 55% of the total in Toronto and Calgary.
* Urban-suburban battles will resume with transit-oriented, mixed-use developments the focus.

Retail

According to the report, urban intensification and retailers' adaptation to e-commerce continue to alter the retail landscape. At the same time, failure to adapt has led to further closings and bankruptcy protection as retailers cull underperforming stores, while foreign brands continue to put down roots and recent entrants, most notably Target, rethink their strategies.

* U.S. retail entrants in 2014 continued and included Marshall's and Nordstrom in Calgary, while 2015 will see Nordstrom unveiling locations in Ottawa and Vancouver. Japanese retailer MUJI opened its first Canadian location in Toronto in 2014.
* Renovations/expansions are prominent, as are openings of new centres, including Carrefour de la Bravoure - a new $50-million project in the Quebec City region that comprises 40 stores in more than 15 buildings.

Industrial

* Largely sporting low, single-digit vacancy rates, Canada's stable industrial markets claimed eight of the 10 lowest vacancy rates in North American markets surveyed by Avison Young.
* Canada's industrial vacancy rate remains tight, dipping 20 bps from year-end 2013 to finish 2014 at 4.2%. Unlike the office sector, vacancy declined in seven of 12 Canadian markets surveyed, with decreases of 10 bps to 180 bps. Leasing will remain steady, but new developments will lift the national industrial vacancy rate to 4.6% by year-end 2015.
* Apart from Halifax, single-digit vacancy rates prevailed in 2014 with eight of the 12 markets surveyed recording rates below the national average (4.2%). With the exception of Halifax, single-digit vacancy rates will reign again in 2015, but will inch higher across the majority of markets.

* Accounting for 71% of the national industrial stock, the Eastern markets saw a 30-bps year-over-year decline in vacancy, averaging 4.4% at the close of 2014. By comparison, the Western markets combined for 3.5% vacancy in 2014, down 40 bps from year-end 2013. The West-East spread of 100 bps will narrow to 50 bps this year.
* Almost 17 msf of industrial product was under construction (30% preleased) at the end of 2014 - equating to less than 1% of existing inventory - 34% ahead of the pace set in 2013.
* Toronto, Canada's largest and North America's third-largest industrial market, remains the biggest Canadian development market with 5.8 msf underway (34% of national total), followed by Calgary (3.9 msf, 23%).

Investment

On the investment front, dispositions continue to drive healthy investment levels in most Canadian markets, while the lack of available quality product masks investors' true appetite for acquisitions. With the final 2014 tally to come, an estimated $22 billion of commercial real estate sold through November 2014. While REITs have lost some steam, pension funds and private investors have filled the void, keeping capitalization rates low for core assets.

Notable blockbuster single-asset and portfolio sale transactions in 2014 included Bayview Village Shopping Centre ($505 million) and the Hudson's Bay office and retail sale/leaseback ($673 million), both in Toronto; Centre 10 ($274 million) and 1500 West Georgia Street ($121 million) office buildings in Calgary and Vancouver, respectively; the IvanhoÃ© Cambridge - Cominar REIT $1.6-billion portfolio sale, which comprised 11 shopping centres, three office buildings and one industrial property in Quebec and Ontario; and the sale by H&R REIT to PSP Investments and Crestpoint of a 50% interest in a portfolio of Canadian and U.S. industrial properties (101 properties comprising nearly 20 msf) for a reported sale price of $731 million.

U.S.

After a year of largely widespread occupier demand, rising employment and improved real estate fundamentals, most U.S. cities are forecasting further progress in 2015. As occurred in Canada, the effects of modernization and improved efficiencies were felt as occupiers looked to cut costs.

"Widespread absorption and recovery in leasing markets was witnessed throughout 2014. Vacancy across all asset types fell and, with a relatively robust employment environment, rental rates increased, driving values higher," comments Earl Webb, President, U.S. Operations at Avison Young.

"Multi-residential development in the U.S. has been robust for several years, while development of office and industrial properties is on the rise. Renovation and repurposing remain significant trends in many Central Business Districts (CBDs), while supply-chain efficiencies and e-commerce are driving the need for more warehouses and storage facilities. A sustained drop in oil prices could hurt energy-driven markets, such as Houston, but could also boost consumer confidence and benefit the retail sector."

Webb continues: "While many global factors could impact specific sectors of U.S. real estate markets in the near term, the maturing economic recovery has led to tightening availability in all sectors, and positioned the U.S. commercial real estate market for further growth in 2015."

Notable report highlights include:

Office

* Overall vacancy in the U.S. office markets that Avison Young tracks (a total of 4.1 billion square feet (bsf)) improved year-over-year (-50 basis bps) and ended 2014 at 13.6%.
* All but eight markets recorded lower rates compared with year-end 2013, and a flight to quality persists.
* Office space under construction totaled 73.5 msf at the end of 2014, up from 69.1 msf one year prior, although the percentage of new construction in relation to existing total inventory was virtually unchanged at nearly 2%.
* The Avison Young markets with the most office space under construction (6 msf or greater) are New York, Houston, Dallas and Washington, DC.
* Preleasing is at approximately 50% nationally; build-to-suit activity is common with few projects being built on a speculative basis.

* Many occupiers of these new buildings are frequently moving from elsewhere within the market, so net occupancy gains are not realized.
* Development is increasingly focused on urban mixed-use projects as tenants' desire for live/work/play environments endures.

Retail

* In the U.S. retail market, resilient absorption rates and receding vacancy characterized the sector in 2014, with shopping centers the only segment to register vacancy in the double digits.
* Retail construction did not intensify in 2014 and, nationally, building starts were at their lowest point in more than three years.
* With no near-term supply concerns, upward pressure on rental rates is expected to persist in 2015.
* Across the U.S., there remains a high demand for retail in ubiquitous town center developments, with retail center sales activity in 2014 up compared with 2013.

Industrial

Avison Young's industrial markets totaled 9.1 bsf at third-quarter 2014 with rising construction levels and overall vacancy of 7.2% supported by a year of strong demand.

Webb notes: "On the industrial front, supply-chain efficiencies and changing retail patterns are driving the need for more warehouses and storage facilities. The combination of economic growth and e-commerce, along with New-Panamax capable ports, will drive gains in industrial markets in 2015."

* At the end of 2014, a total of 93.3 msf was under construction, a 37% increase from 2013 levels. While noteworthy year-over-year, this amount is well below the all-time peak (2007) when 180 msf was under development.
* Cities that comprise the bulk of the construction activity include Los Angeles, Chicago, Atlanta, Philadelphia and Dallas.
* Tight market conditions and a dearth of big-block opportunities are driving warehouse construction by large occupiers such as Amazon.com, which has projects proceeding in multiple U.S. markets.

Investment

Investment sales transactions were up considerably in 2014, and third-quarter volume was 11% higher year-over-year with multi-residential and CBD office properties leading the gains.

* Investors are increasingly looking at secondary markets.
* Multi-residential and CBD office assets recorded the sharpest cap-rate decline even as all sectors trended lower.
* Foreign capital continued to seek U.S. property acquisitions and, not surprisingly, the Northeast, West Coast and Chicago areas garnered the largest share of the nearly $50 billion invested.
* Canadian investors outpaced the next closest sources of foreign investment - China and Norway - by more than double.

"We should start to see a gradual stabilization in bond rates and, in fact, may begin to see a slight uptick in related borrowing costs as lenders begin to price-in forward rate increases," says Webb. "However, real estate remains a preferred asset class for most institutional investors - domestic and foreign - and the yields on quality assets remain well above comparable-risk bonds."

Webb concludes: "The availability of capital and attractive yields will support the demand for real estate investments. We will be able to withstand an uptick in borrowing costs, and demand is likely to continue to outpace supply in 2015."