



## HIGHLIGHTS

- Canada's office market has taken a hit from the recession, but conditions remain stable relative to the U.S.
- Western Canada has suffered a more severe reversal in office market conditions than Eastern Canada
- The next two years will present considerable challenges to Canada's regional markets as new supply comes on stream during a period of relatively sluggish demand growth, a trend which is typical for commercial property markets following a recession
- In particular, the Calgary market will face a slow return to a balanced market

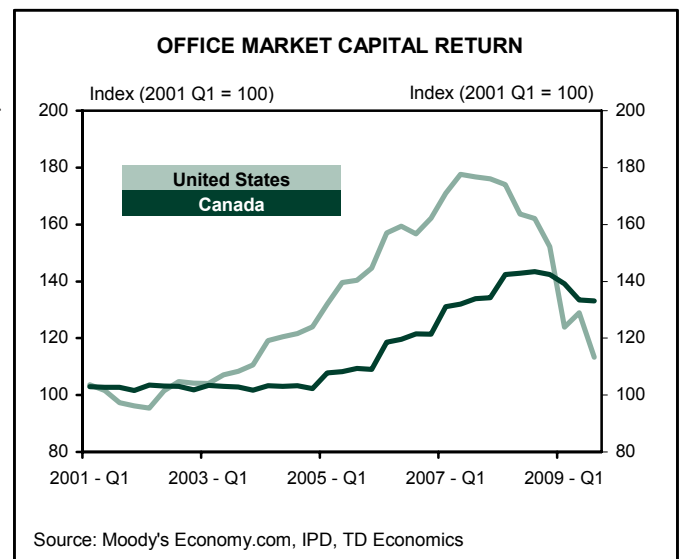
## CANADA'S OFFICE MARKET – AN EAST AND WEST SIDE STORY

The sharpest division between the Canadian and American economies over the past two years has been the health of the residential real estate market in Canada relative to the meltdown in the U.S. Now that the American commercial real estate market is tumbling, it is appropriate to ask whether Canada's market will suffer a similar fate. In this note we find that the Canadian office market will remain a tower of strength compared to the American market, but it has nevertheless fallen on much tougher times than the housing market.

More specifically, conditions across the six largest markets – Toronto, Montreal, Ottawa, Calgary, Edmonton, & Vancouver – have deteriorated dramatically since the onset of the recent economic slump in mid-2008. In particular, each of the metro markets has experienced a combination of falling demand and increasing supply, which has pushed up office vacancy rates from coast to coast to the highest levels in four years. The most substantial deteriorations have been chalked up by western markets, which had experienced more froth during the peak of the commodity cycle in 2006-08.

There are emerging signs that the demand for office space may have started to turn the corner in tandem with local economies and job markets. In Q4 2009, demand for office space rebounded modestly in all markets, with the sole exception of Montreal. But with ongoing increases in total office supply more than offsetting gains in demand, vacancy rates continued to tick higher in the majority of these markets. These Q4 performances are likely to provide a taste of things to come, at least in the near term.

Economic recoveries across the country are expected to be gradual in nature, and with further additions to office space expected to come on-stream in the quar-



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\* For the purposes of this paper, we define Canada's office market as all classes of property in the downtown and suburban markets for the greater metro areas of Canada's six largest markets: Vancouver, Calgary, Edmonton, Toronto, Ottawa and Montreal.

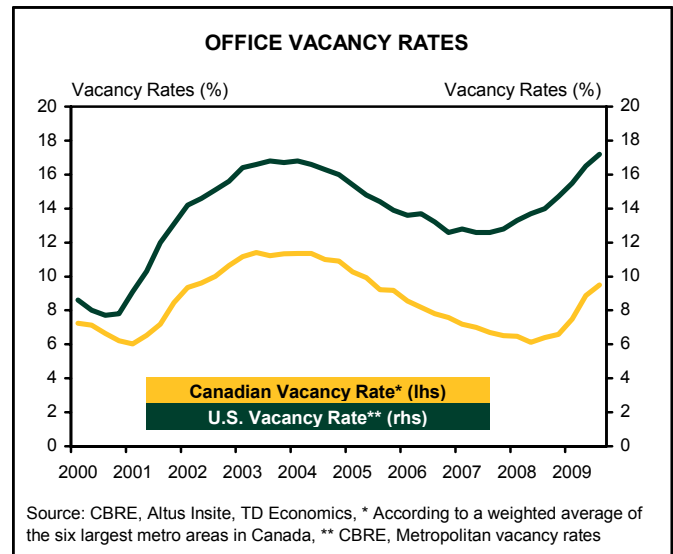
ters ahead, vacancy rates are poised to head higher in 2010 and to decline only slightly in 2011. Given that commercial property markets typically lag the economic cycle, this delayed increase in vacancy rates is not unusual. As such, we expect to witness ongoing excess supply in commercial real estate markets until 2012 at the earliest – especially in Calgary, Montreal and Toronto, where vacancy rates are likely to remain well above their long-term average.

**Canada’s market a tower of strength compared to U.S.**

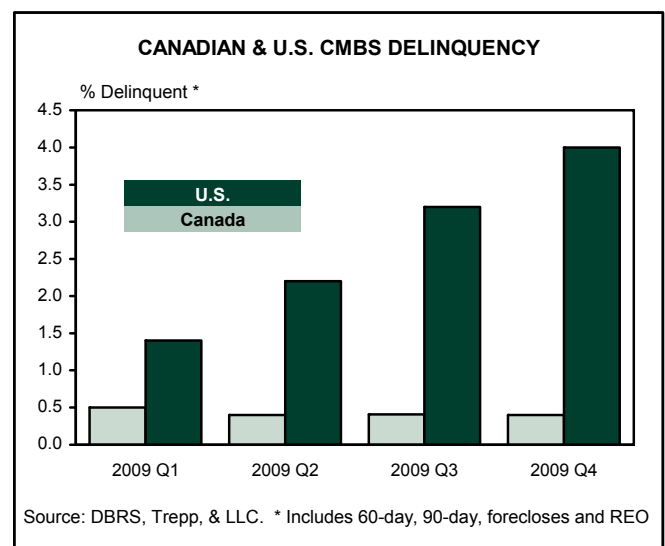
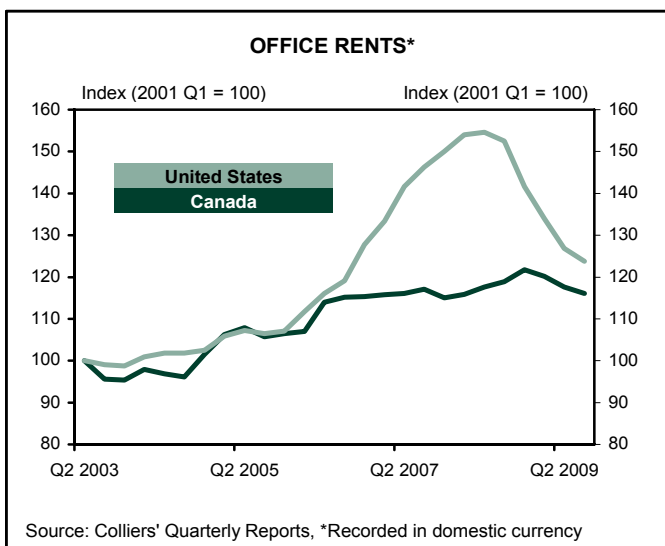
While Canada’s overall office market has been struggling, it remains a pillar of stability relative to the U.S. market, which has been on a particularly wild ride over the past few years. We chronicled the challenges in U.S. commercial property market in a recent publication “U.S. Commercial Real Estate is a Speed Bump, But Not a Road Block to Economic Recovery.”

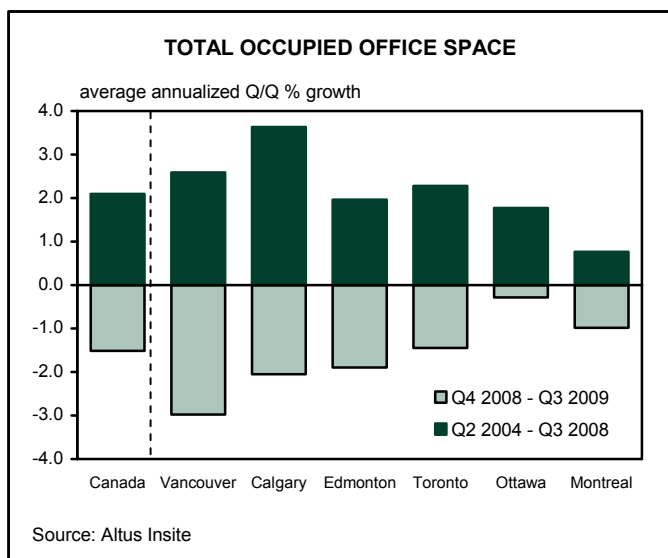
Given methodological differences in commercial real estate data, comparing recent performances in Canadian and U.S. property markets must be carried out with caution. At the same time, however, we believe that meaningful inferences can be drawn from some of the broad indicators. According to Moody’s, after surging by 72% between Q1 2003 and the peak in Q2 2007, the price of U.S. office buildings has since retraced almost all of these gains. In comparison, Canadian capital returns – a proxy for the price of office space – rose by a more measured 38% between Q1 2003 and Q1 2008 and have slipped only slightly since the economy fell into recession. As can be seen in the accompanying chart, these trends were mirrored by office rents.

At first glance, trends in commercial office vacancy rates



appear at odds with the relative froth in U.S. rents and prices compared to those in Canada. In fact, U.S. vacancy rates remained above Canadian rates and were falling at roughly the same pace during the boom period of 2004-07. As noted, this could partly reflect measurement issues. Another explanation – and one that we believe has considerable merit – is linked to the excessive risk taking in the U.S. market, which had caused prices and rents to become disconnected from fundamentals prior to the financial crisis. While the U.S. housing market remained the epicentre of risky lending behaviour in the U.S. financial system, some of this culture undoubtedly spilled over to the commercial property market. As a result, when credit markets froze beginning in the summer of 2007, U.S. commercial property was not spared. Indeed, about one-quarter of U.S. commercial property mortgage assets were held by investors of com-





services kept demand for office space high. Across the western markets, vacancy rates fell below 5%, with Calgary's rate actually slipping to as low as 1.5% at the beginning of 2007 before the availability of some additional office space helped boost vacancy rates to still-ultra-low levels of 3.8% throughout 2007 and 2008. The tightness in the markets was reflected in dramatic rent increases. Not surprisingly then, the subsequent slump in commodity prices and deeper economic contractions have led to a particularly severe reversal in property market conditions out west.

In contrast, the eastern markets of Toronto, Ottawa and Montreal experienced a less notable run-up during the boom period and, thus, have experienced relatively smaller declines in demand for office space and less pronounced increases in vacancy rates since the recession started mid-way through 2008.

Looking ahead, the seeds have been planted for a gradual recovery in office demand as net employment creation – a good proxy for office demand – resumes across Canada's regional markets. Still, the biggest near-term challenge in the market will be the excessive supply of office space. Not only are a number of high profile projects in markets such as Calgary and Toronto poised to come on stream during 2010 and into 2011, but businesses will likely remain somewhat hesitant to expand office demand in an environment of tepid economic recovery.

We now take a closer look at the prospects for these individual markets. Figures on market performances and outlooks are contained in the table on page 7.

No other major Canadian office market recorded such a dramatic tightening in conditions as **Vancouver** between early 2004 and mid-2008, evidenced by the city's 8 percent-

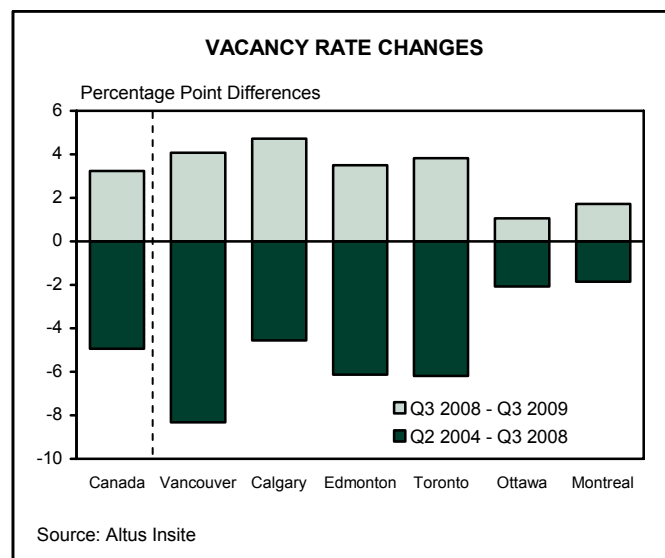
mercial mortgage backed securities (CMBS), which were particularly hard-hit by the credit crisis. Chartered banks, and notably small regional banks in the U.S., account for about half of total commercial mortgage assets.

Not unlike the story in the housing market, risk-taking in Canada did not appear as endemic pre-recession. And in the aftermath of the financial crisis, the relative health of the country's financial institutions has helped to soften the market's adjustment, as lending has continued to flow more freely compared to south of the border. In a survey conducted by PriceWaterhouseCoopers, only 31% of Canadians felt the real-estate debt market would be substantially undersupplied in 2010 compared to 75% of Americans. Also contributing to the stability of the Canadian office market is the importance of pension funds as key equity holders because of their long term investment horizon. For instance, Canada's pension funds hold roughly 12% of their assets in real estate property – including office buildings.

**Western Canadian markets have been on a wild ride compared to eastern**

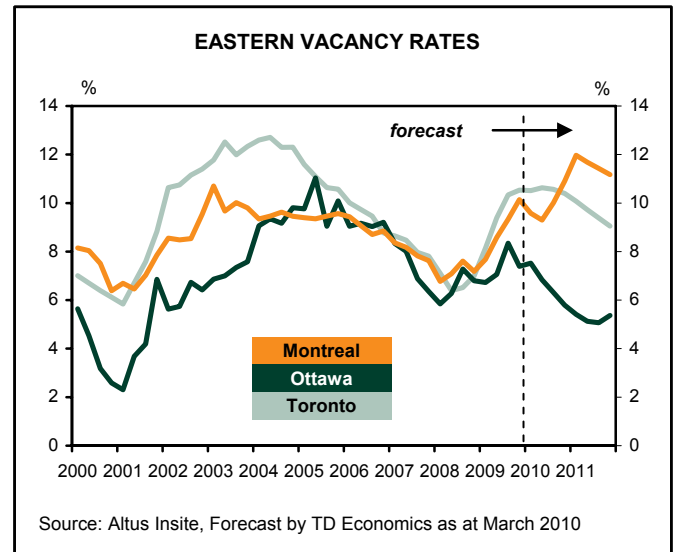
To be fair, Canada is not one office market, but a collection of regional markets that are facing different challenges and opportunities. So while Canada's overall office market has been less prone to the unhealthy gyrations of its U.S. counterpart, not all of the country's large markets can be painted with the same brush.

Out west, with commodity prices racing ahead in 2006-08, conditions in the resource-based markets of Calgary and Edmonton had shown signs of overheating pre-recession. Meanwhile, strong growth across Vancouver's diversified



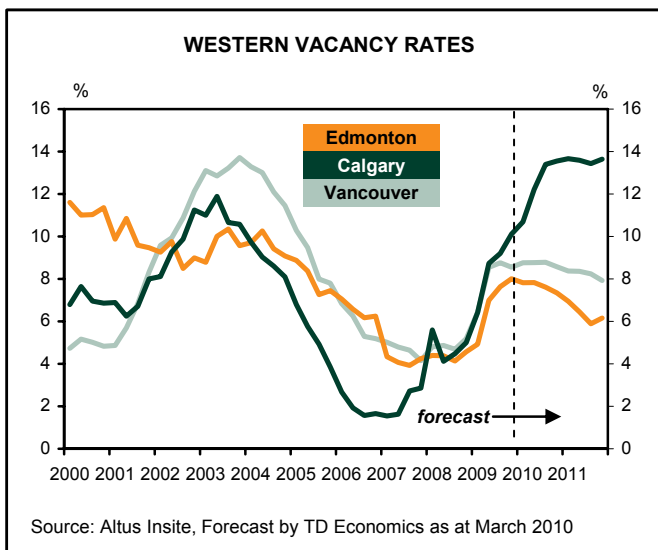
age point decline in the office vacancy rate over the period. This change reflected a booming job market, strong increases in demand for office space and a lack of additional supply. Since then, the vacancy rate has almost doubled to nearly 9%. The uncertainty surrounding the economic crisis in 2008 appears to have left the biggest dent in the Vancouver market. Even though employment has held up reasonably well during the recession, total occupied space fell by a whopping 3% annualized average rate between Q4 2008 and Q3 2009. The impact on the vacancy rate was mitigated by the fact that additions to office space over the period were less than the all-market average. As uncertainty continues to gradually lift in 2010, and as the economic recovery becomes more firmly entrenched, some of the recent fall in demand should reverse. On the flip side, the end of the 2010 Winter Olympics will result in some office space being freed up, leaving overall demand growing at a relatively modest rate this year. Over the next two years, new supply is set to grow by a healthy 2.5% pace across the greater Vancouver marketplace. Since opportunities for development in the downtown market remain limited, the bulk of new space will emerge in the suburbs of Burnaby and Surrey, as major projects including the Metrotower III and the Benchmark Business Centre II are finished.

Although **Calgary's** formally-overheated office market was showing distinct signs of easing prior to last year's recession - as new projects were coming on stream to address the severe shortage of office space - the massive reversal in crude oil and natural gas prices in 2008 and into 2009 dealt a particular blow. Since the final quarter of 2009, however, demand conditions appear to be stabilizing. Total occupied space rose at an annualized rate of 1% - its first quarterly



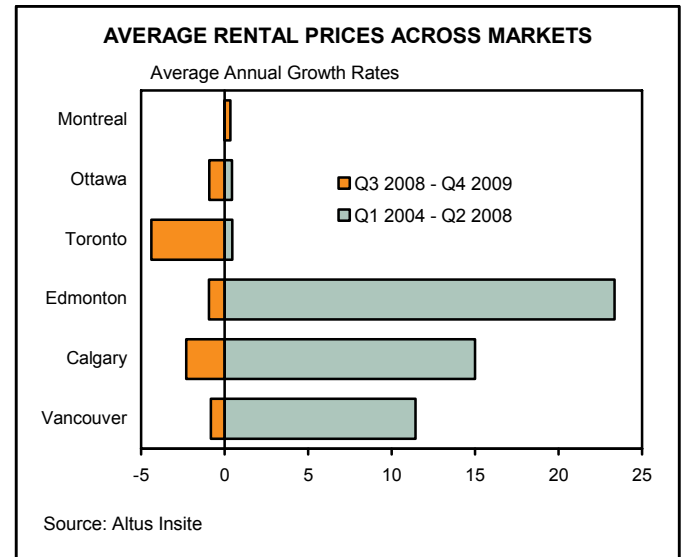
gain since Q4 2008. Our forecast of crude oil (about US\$75 per barrel on average) and natural gas prices (US\$6 per MMBtu) over the next two years should support a continued moderate, but not booming, recovery in office demand. Nonetheless, this pace of demand in office space is unlikely to fully absorb the glut of new office space. As another 3.0% of new space was added to the market in 2009, the vacancy rate rose to 10.1% in Q4 2009. Looking forward, a number of new projects are expected to keep the stock of office space and the overall vacancy rate on a significant upward trend. During 2010, completion of the Centennial Place East and West Towers in the downtown core will contribute to a 5.0% annual increase in Calgary's total office space. Following this, 2011 will offer little respite as two mega projects – The Bow and The East Tower of Eight Avenue Place – should help add another 5.0% of new office supply. Between Q4 2008 and Q4 2009, average rental prices have fallen by nearly 4.0%, while landlords have started offering numerous incentives – such as improved renovation budgets – to attract and retain tenants.

While perhaps not quite paralleling Calgary in terms of froth, **Edmonton's** office market had tightened dramatically prior to the onset of recession in mid-2008. Indeed, although demand for office space averaged a relatively measured 1.6% per year between early 2004 and mid-2008, this pace managed to outstrip even weaker gains in new supply (1.1%). So by mid-2008, Edmonton's vacancy rate had a similar 4-4.5% as both Calgary and Vancouver. Edmonton's position as a supply and service hub of the oil sands means that improved price conditions in the oil market and the rekindling of oil sands activity are likely to provide a boost to both employment growth and office demand in the coming

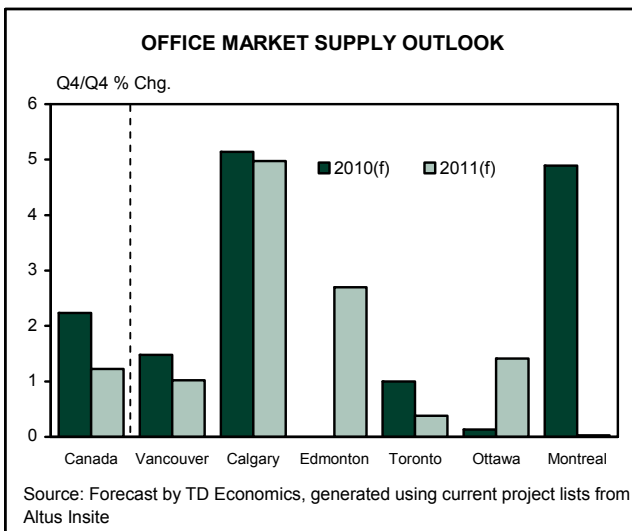


quarters. At the same time, unlike Calgary, there are limited new big-ticket office projects set for completion until 2011, pointing to a significant tightening in market conditions this year. Next year, the demand side in Edmonton could lose a step as the Alberta government likely begins to rein in spending growth in the province's capital city.

Despite the negative impact of a high Canadian dollar on its export-oriented manufacturing sector, **Toronto's** property market tightened considerably in the run-up to the recession in 2008-09. Strength in financial and business services had supported steady demand growth since mid-way through the last decade. On the surface, Toronto's vacancy rate of more than 6% at its peak during 2008 did not point to a market in excess demand. But a much different perspective is reached when it's considered that Toronto's long-term average (a proxy for its structural rate) has run above 9%. This structural rate reflects in part high commercial property taxes and the relatively lofty overall cost of locating in the city's downtown core. Regardless, demand was robust between 2004 and 2008 as Toronto experienced the largest percent increase in rental prices among the major eastern markets. Even though Toronto's relatively healthy financial service sector stood the region's economy in good stead during the 2008/09 downturn, supply-side growth – notably, a slew of completed projects just as the recession got underway including the Bay-Adelaide Tower, the RBC Centre, & 25 York Street - has been instrumental in pushing up the vacancy rate towards 10% by the end of last year. There is limited scope for vacancy rates to drop in 2010, as job creation remains relatively muted and another 1% gain in office space is expected. With fewer projects on tap for 2011, the door should be open for a meaningful tightening in the market by 2012.



As other markets have experienced substantial swings, **Montreal's** office vacancy rate has been relatively stable, remaining in the 7-9% range for much of the period dating back to 2004. This relative stability is largely due to generally slow growth in both the economy and demand for office space during the pre-crisis expansion, as well as the economy's well-diversified structure, which helped to limit the economic hit during the recent downturn. Montreal's economy consists of a well-balanced mix of services and goods-producing industries. And while the beleaguered manufacturing sector is a major contributor to the economy, Montreal's exposure on that front is also spread out across a range of industries. That being said, the latest quarterly office data (Q4 2009) show a large decline in demand for office space and a spike in the office vacancy rate, which rose to a seven-year high of just above 10%. We caution reading too much into sharp quarter/quarter moves, since it might reflect transactions that haven't been fully reflected in the data. For example, a company leaving the downtown for the suburbs might have an immediate impact on the downtown office vacancy rate; but, due to timing differences, fail to be captured immediately in an offsetting lower suburban rate. Still, regardless of any near-term volatility, the likelihood of considerable projects coming on stream in 2010 promises to drive the vacancy rate even higher in the coming quarters. It should be mentioned that most of this new supply is lower class 'B' and 'C' property. As a result, the market for class 'A' properties will remain stronger than the headline figures suggest. What's more, just as the economy held up better than average during the recession, we see less scope than other markets for a rebound in employment in 2010 and into 2011.





**Ottawa** experienced steady growth in demand during the 2004-08 period, as both the public and private sectors expanded at a healthy clip. Indeed, stimulus spending by the federal government during the recent recession has been a stabilizer in the Ottawa economy, and as such, the market has recorded the smallest increase in its office vacancy rate among the six major markets since mid-2008. In 2010, the prospect of rising demand and stagnant supply are likely to drive down the vacancy rate to just over 5% by year-end, about half of the all-market average. This tightness is likely to prove temporary, as frozen departmental operating budgets and promised but unspecified program cuts will require the federal government to downsize aspects of its operations into the foreseeable future. The supply outlook will be largely influenced by a federal government decision

to develop some of its existing downtown property.

**Bottom Line**

While not being as severely affected as its U.S. counterpart, Canada's overall office market has still taken a hit from the recession. Over the next two years, Canada's regional office markets will face considerable challenges as new supply comes on stream during a period of relatively sluggish demand growth. Thus, we anticipate conditions of excess supply will put downward pressure on rents across most Canadian office markets until at least 2012, which is not unusual given the lagged nature of commercial property markets. Calgary in particular faces a slow return to a balanced market.



Greater Metro Area Office Markets *							
	Canada ^	Vancouver	Calgary	Edmonton	Toronto	Ottawa	Montreal
<b>Total Occupied Space (Average Annualized Q/Q % Growth)</b>							
Q2 2004 - Q3 2008	2.1	2.6	3.6	2.0	2.3	1.8	0.8
Q4 2008 - Q3 2009	-1.5	-3.0	-2.0	-1.9	-1.4	-0.3	-1.0
Q4 2009	0.5	1.9	1.0	2.4	0.8	4.2	-3.5
<b>Total Office Space (Average Annualized Q/Q % Growth)</b>							
Q2 2004 - Q3 2008	0.8	0.3	2.3	0.5	0.7	1.3	0.3
Q4 2008 - Q3 2009	1.3	0.5	2.0	1.1	1.9	0.6	0.5
Q4 2009	1.6	0.9	5.1	4.0	1.7	0.0	0.0
<b>Vacancy Rates (%)</b>							
<b>Level (%)</b>							
Q2 2004	11.2	13.0	9.0	10.3	12.7	9.4	9.5
Q3 2008	6.2	4.7	4.5	4.1	6.5	7.3	7.6
Q3 2009	9.5	8.8	9.2	7.6	10.3	8.3	9.3
Q4 2009	9.7	8.6	10.1	8.0	10.5	7.4	10.1
<b>Change (percentage points)</b>							
Q2 2004 - Q3 2008	-4.9	-8.3	-4.6	-6.1	-6.2	-2.1	-1.9
Q3 2008 - Q3 2009	3.2	4.1	4.7	3.5	3.8	1.1	1.7
Q3 2009 - Q4 2009	0.3	-0.2	0.9	0.4	0.2	-1.0	0.8
<b>Total Employment (Average Annualized Q/Q % Growth)</b>							
Q2 2004 - Q3 2008	1.7	2.3	4.0	2.4	1.8	2.7	1.0
Q4 2008 - Q3 2009	-1.4	-0.4	-0.2	-0.2	-1.8	-0.7	-0.7
Q4 2009	1.3	0.7	4.3	-2.7	3.8	2.4	1.5

Source: Altus Insite, Statistics Canada \* The three different time periods used in this table have been selected to reflect market tightening during 2004-2008, the impact of the recession, and the most recent uptick in demand.

^ Refers to weighted average of the six major markets

Greater Metro Area Office Markets: Outlook							
	Canada ^	Vancouver	Calgary	Edmonton	Toronto	Ottawa	Montreal
<b>Total Occupied Space Growth (Q4/Q4 % Chg.)</b>							
2009	-1.9	-2.9	-2.6	-2.0	-1.2	0.1	-3.1
2010(f)	1.8	1.7	1.5	1.1	1.4	2.4	2.8
2011(f)	1.9	2.2	3.1	2.4	2.0	0.6	1.2
<b>Total Office Space Growth (Q4/Q4 % Chg.)</b>							
2009	1.7	0.7	3.0	1.7	2.7	0.8	0.0
2010(f)	2.2	1.5	5.1	0.0	1.0	0.1	4.9
2011(f)	1.2	1.0	5.0	2.7	0.4	1.4	0.0
<b>Vacancy Rates (%)</b>							
<b>Level (%)</b>							
2009	9.7	8.6	10.1	8.0	10.5	7.4	10.1
2010(f)	10.1	8.3	13.2	7.0	10.2	5.3	11.9
2011(f)	9.5	7.3	14.7	7.3	8.7	6.0	10.9
Long Run Average ***	8.4	8.0	6.6	7.9	9.4	7.1	8.4
<b>Change (Q4/Q4, percentage points)</b>							
2010 - 2009	0.4	-0.2	3.1	-1.0	-0.4	-2.1	1.8
2011 - 2010	-0.6	-1.1	1.5	0.3	-1.5	0.8	-1.0
<b>Employment (Annual Average % Growth)</b>							
2009	-1.6	-2.3	-1.2	-1.2	-2.4	-2.4	-0.9
2010(f)	0.9	1.4	0.7	0.7	1.2	1.2	0.4
2011(f)	1.9	1.9	2.5	2.5	2.0	2.0	1.8

Source: Altus Insite, Statistics Canada, Forecasts by TD Economics as at March 2010 ^ Refers to weighted average of the six major markets, \*\*\* From Q1 2000 - Q4 2009