POV

Point of View

Q3 2018

Downtown and Beltline Office Market Report

Market OVERVIEW

Downtown Market

Calgary's summer of 2018 was three things – hot, hazy, and short-lived. No, we are not talking about the weather, we are talking about the market for commercial real estate. We saw an uptick in absorption, increased uncertainty about the future of the market, and an increase in leasing activity that may be short-lived.

While the city itself may have seemed sleepy through summer holidays, we just experienced one of the strongest quarters for office leasing since 2012. On the surface, 204,968 sf of positive absorption – or approximately a 0.4% vacancy decrease – may not seem like much in the way of activity. However, there is far more to the leasing picture than what we can see on the surface.

One of the biggest impacts to vacancy figures in Q3 was the anticipation of 320,000 sf of sublease space from Cenovus in the new Brookfield Place Calgary - East Tower coming to market. Though we cautiously anticipated that this sublease vacancy could flood the market and impair absorption coming into the fall – which was endorsed by historical trends showing Q3 as the slowest quarter for leasing (see: Cresa's Q1 Point of View) – our worry was fortuitously misplaced. While Cenovus's space provided a bump in inventory, it was offset by a material quantity of leasing. Excluding the sublease space anticipated in Brookfield Place Calgary, which has existed as ghost space for some time, approximately 525,000 square feet of space was leased over the summer.

Large, contiguous blocks of AA and A class space were leased by companies from the energy and financial services sectors in the third quarter. Some of these groups moved into the core from suburban Calgary, lowering downtown vacancy while pulling tenancy away from other markets; others expanded their existing footprint in the downtown core. Large transactions included:

- Parkland Fuel Corporation
- BMO Financial Group
- Sinopec Canada Energy Ltd.
- Trinidad Drilling Ltd.
- Pembina Pipeline Corporation
- CES Energy Solutions Corporation
- Serafina Energy Ltd.
- Packers Plus Energy Services
- MLT Aikins LLP
- Telus
- Aviva Canada

What do these transactions say about the market? At first glance, it appears that the market is picking up. Oil prices seem to have stabilized, despite continuing differentials for Canadian petroleum products, and we are seeing early signs of economic diversification as firms from outside of the energy sector are moving to Calgary or are entering into real estate transactions to facilitate growth. On the other hand, we are not seeing significant quantities of investment dollars entering Alberta from outside of the province, and the growth that we are experiencing looks to be primarily organic in nature. Without access to capital from both local and foreign players, it should be difficult to fill any significant quantity of space in downtown Calgary. The city needs major projects with real job creation in order to move the vacancy rate downwards at a material pace. That does not mean that we will not continue to see improvement, though.

These transactions also speak directly to the characteristics of available commercial real estate in Calgary. Of the aforementioned transactions, there was a fairly even split of sublease and

Market OVERVIEW

headlease transactions. There are two easy explanations for the headlease-to-sublease ratio. The first is the availability – or lack there of – of "ready-to-go" sublease spaces; as the market has matured through the present downturn, the sublease spaces that were completely move-in ready, with reception, appropriate meeting rooms, and other core features have garnered the most demand. The remaining spaces, which were typically "working floors", lacked the amenities that a single floor tenant requires. The second explanation is the age of improvements within many of the remaining sublease spaces. Between the early 2000s and 2008, when commodity prices boomed, new office space was constructed throughout downtown Calgary. Space of that vintage is approaching an age of 10 to 15-years-old, and is outdated with respect to the office designs of today. Now, as tenants search for spaces that do not require their own investment on the front-end of a real estate transaction, landlords are stepping up with turn-key opportunities and major tenant inducement packages to attract tenants.

Regardless, between tangible leasing and reduced market "slack", we saw a strong quarter for downtown leasing, particularly in the AA and A classes. Let us look at each market class separately:

AA Class – The AA class continues to carry the lowest vacancy, currently sitting at 17.01%. The majority of AA class vacancy remains as sublease vacancy, representing two thirds of the available space. Despite the addition of anticipated sublease space, large tenant transactions, and continued merger & acquisition activity, total AA class vacancy stayed flat, in part due to our reclassification of Millennium Tower from AA class to A class.

A Class – The A class segment saw the most leasing in Q3. While it benefited from the Millennium Tower reclassification, some of the largest transactions of the quarter also occurred in the A class, headlined by Parkland Fuel in BP Centre.

B Class – The B class continues to bleed vacancy, as it has done since 2012. The "flight to quality" is very real, and the B class is its greatest victim. Vacancy in the B class now stands at 39.32%. Smaller tenants are exceedingly common in B class buildings, and it is difficult for B class landlords to lease-up large chunks of space with the same frequency that AA and A class landlords are able to.

C Class – The "discount class" still has an important niche in this economy, providing ultra-low-cost options to tenants who are looking for them. C class vacancy is slightly better than the market average, at 23.84%, and witnessed positive absorption in the third quarter to the tune of 20,843 sf, or approximately a raw 3%.

Beltline and Fringe Markets

Vacancy in the Beltline continued to trend higher in the third quarter, with the vacancy rate reaching 24.00% after last quarter's rate of 22.63%. The migration of tenants from suburban Calgary – and the Beltline – into downtown continues to drag on occupancy figures. Fortunately for Beltline landlords, we did witness larger tenants from south and north suburban areas move into the Beltline in the third quarter. The Beltline continues to function as a central alternative for companies looking to stay out of the core, as it boasts greater access to parking and reduced commute times. Tenants in the Beltline can look for similar rates to those found in downtown Calgary, in addition to competitive inducement packages.

Downtown's other fringe areas are seeing more competition over space and rates. In Mission, Kensington, and Inglewood/Ramsay, vacancies between 5,000 and 10,000 square feet are few and far between. At the time of writing this report, each of those three markets only had two vacancies in the aforementioned size band. Smaller tenants have more optionality in the fringe markets – particularly those under 3,000 sf – but there are still very real limitations. Please refer to Table One for the current vacancy rates for the fringe markets.

Market FORECAST

Much like the weather, blanketing the city with smoke for most of the third quarter, Calgary's market for commercial real estate failed to provide us with any real clarity in the summer of 2018. Now, progressing through a cool "fall", we are hoping that icy conditions do not mimic our opportunities for absorption in the downtown core.

As described in our market report, the third quarter was, comparatively spending to recent years, a big quarter for absorption. Keeping that in mind, consider the following:

- Calgary's unemployment rate climbed to 8.2% in August, up from 7.9% in July, and stands as the second highest municipal rate in the country
- The Conference Board of Canada is forecasting real GDP growth in Alberta at 2.2% in 2019, down from 2.6% in 2018
- Vacancy is still at 24.5%, despite the relatively active quarter Calgary just experienced

Take in the above. Now, not to dampen the mood, but we need tempered optimism. Yes, material leasing of commercial real estate happened in the third quarter. Yes, the vacancy rate moved in a positive direction for the first time in a long time. No, Cresa does not anticipate sustained quarters like the last one.

So, what can Calgary expect into the end of 2018 and the start of 2019? While the future is difficult to predict, we have a few good clues with respect to what to look for in the following months.

A. Further consolidation in the energy sector, leading to staffing redundancies

- The pending acquisition of Trinidad Drilling by Precision Drilling
- The proposed acquisition of MEG Energy by Husky Energy

B. Residual personnel adjustments with respect to large corporate transactions from the first three quarters of 2018, primarily pertaining to employment overlaps

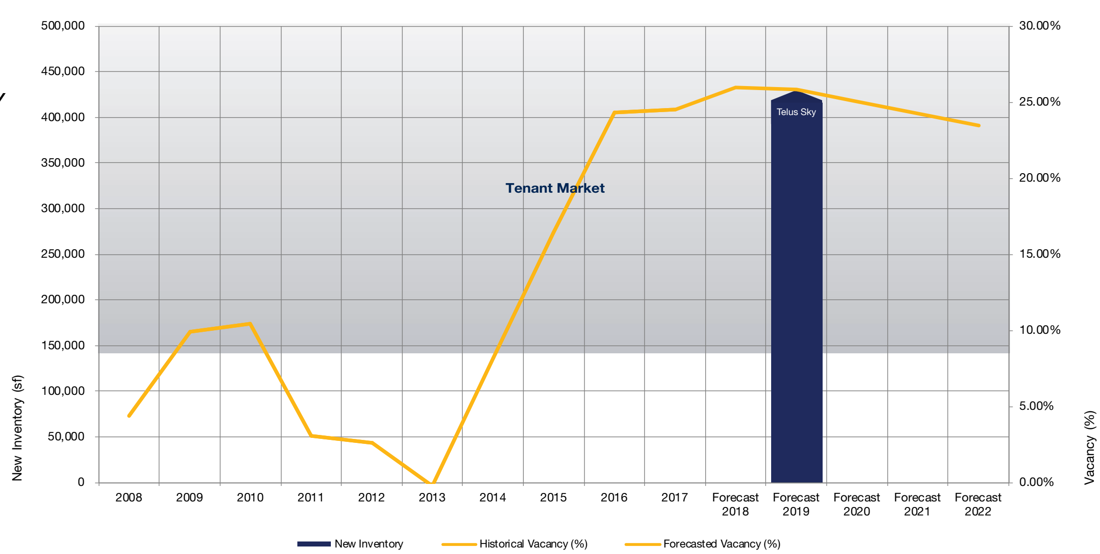
C. The first investments from the Opportunity Calgary Investment Fund (OCIF), which should help local employers add new bodies to their teams

D. Optimism over the confirmation of Shell's LNG project in Northern British Columbia, which has the potential to be a boon for Calgary employment

International and national macro-economic forces will add further complexity to the economic picture in Calgary. Several economists cheered the resolution of the new USMCA trade agreement, although its impacts remain to be seen. Tariffs on steel and aluminum are still in tact between the United States and Canada, and continue to be a point of contention between the two countries. The Western Canadian discounts for both oil and gas are near all-time highs, and we still do not have the answers we need on the TransMountain pipeline to have confidence that we can solve our energy transportation issues. We are treading in uncertain times and repercussions of federal decisions remain to be seen with respect to Alberta's and Calgary's economies.

Going forward, we are hesitant to predict a material decline in downtown vacancy over the course of the next six-to-twelve months. Expect modest fluctuations to the vacancy rate and a moderately flat leasing environment, strongly maintaining Calgary's standing as a "tenant's market". The cold weather may have arrived early, but we expect market conditions to mirror a typical Calgary winter – cool, cloudy, and the beneficiary of the odd chinook breeze.

Graph ONE
FORECASTED VACANCY



Click here to view vacancy details

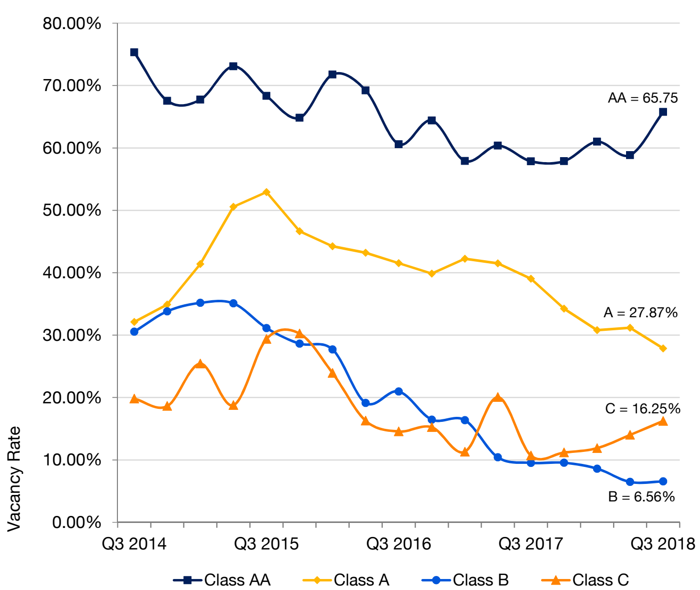
Table ONE

Q3 2018 VACANCY SUMMARY

BUILDING CLASS	TOTAL INVENTORY (sf)	HEADLEASE (sf)	HEADLEASE (%)	SUBLEASE (sf)	SUBLEASE (%)	TOTAL (sf)	TOTAL (%)
Downtown							
AA	15,960,873	929,960	5.83%	1,785,525	11.19%	2,715,485	17.01%
A	17,451,204	3,151,232	18.06%	1,217,396	6.98%	4,368,628	25.03%
AA/A	**33,412,077**	**4,081,192**	**12.21%**	**3,002,921**	**8.99%**	**7,084,113**	**21.20%**
B	7,539,393	2,786,722	36.96%	194,401	2.58%	2,981,123	39.54%
C	2,584,781	516,117	19.97%	100,115	3.87%	616,232	23.84%
Total Downtown	**43,536,251**	**7,384,031**	**16.96%**	**3,297,437**	**7.57%**	**10,681,468**	**24.53%**
Beltline and Fringe Area							
Beltline	6,785,144	1,074,910	15.84%	553,232	8.15%	1,628,142	24.00%
Kensington	604,702	58,171	9.62%	0	0.00%	58,171	9.62%
Inglewood	461,985	23,776	5.15%	9,427	2.04%	33,203	7.19%
Mission	937,532	148,034	15.79%	6,509	0.69%	154,543	16.48%
Total Beltline & Fringe Area	**8,789,363**	**1,304,891**	**14.85%**	**569,168**	**6.48%**	**1,874,059**	**21.32%**

Graph TWO

SUBLEASE VACANCY INDEX



Graph THREE

COMPARATIVE VACANCY

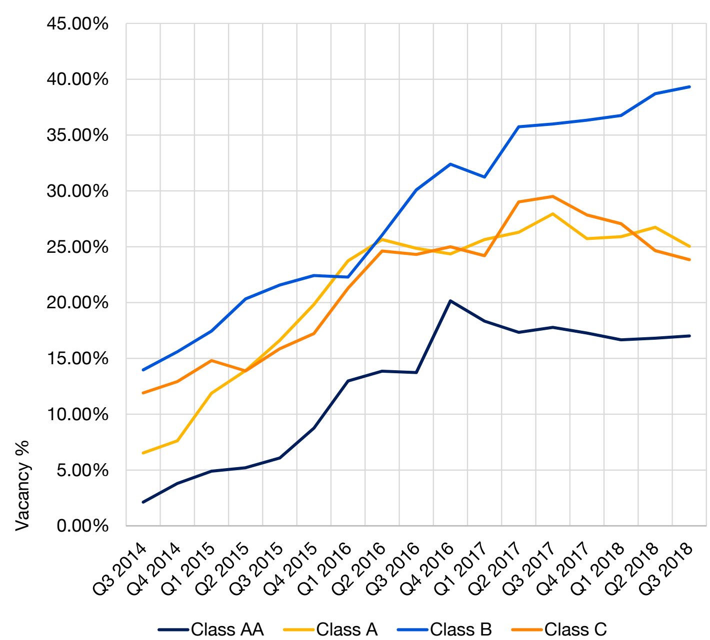
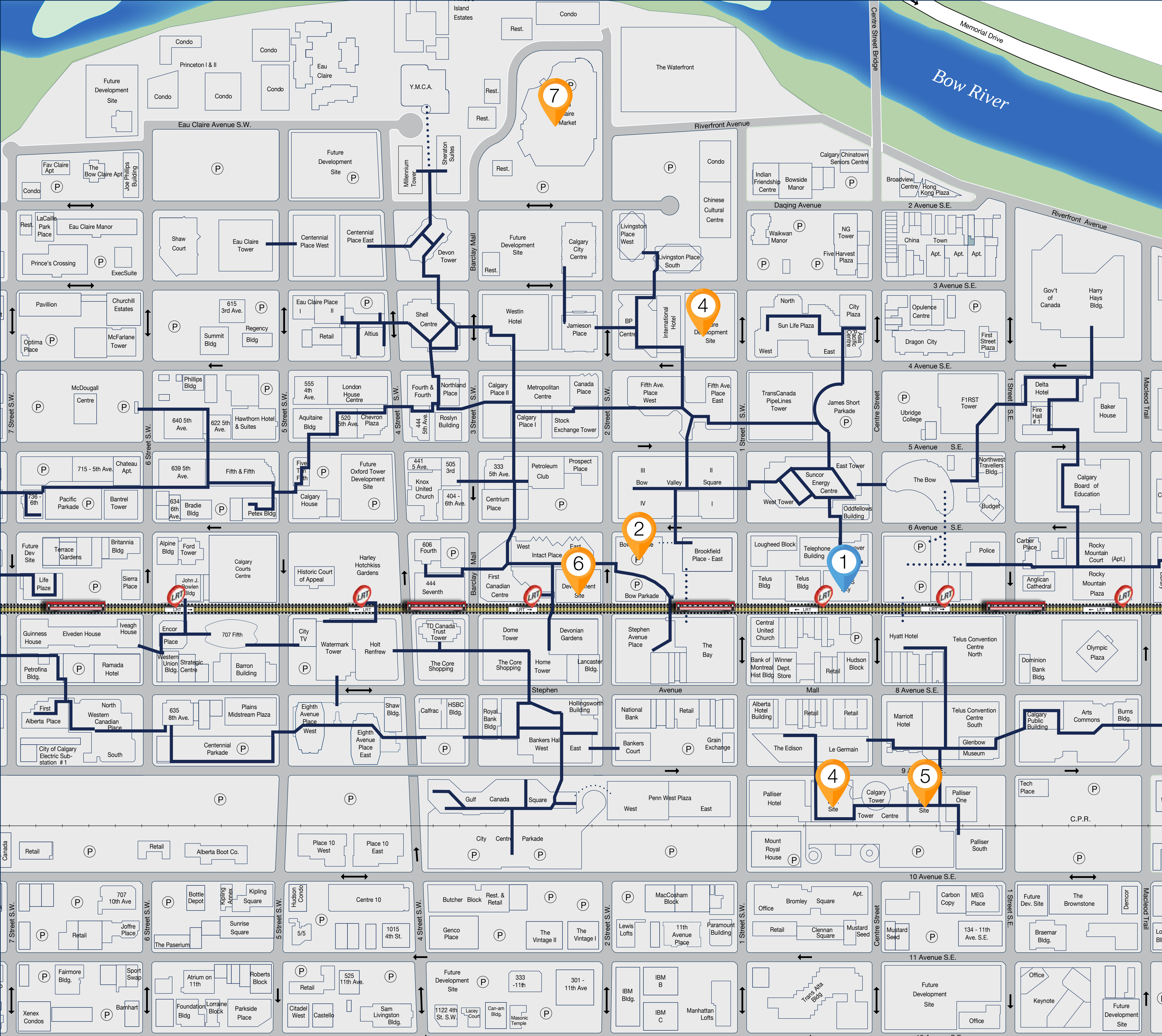


Table TWO

LARGE BLOCKS OF AVAILABLE CONTIGUOUS SPACE, DOWNTOWN CALGARY

Buildings	Type	Area (sf)
The Bow	Sublease	321,077
Brookfield Place - East	Upcoming Sublease	320,869
Telus Sky	Upcoming Headlease	286,172
Brookfield Place - East	Headlease	265,000
707 Fifth	Headlease	261,056
Penn West Plaza - East	Sublease	196,539
Gulf Canada Square	Sublease	193,604

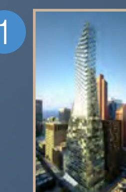
Building	Type	Area (sf)
F1RST TOWER	Headlease	177,352
Stephen Avenue Place	Headlease	134,111
Hanover Place	Headlease	126,211
Lavalin Centre	Headlease	119,366
The Edison	Headlease	118,826
The Bow	Sublease	116,165



New DEVELOPMENTS

DOWNTOWN

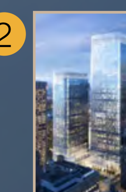
1



TELUS Sky

Landlord:	Telus, Westbank & Allied REIT
Office Floors:	26
Office Area:	430,000 sf
Ave. Floor Plate:	16,500 sf
Est. Completion:	2019
Percentage Leased:	36%
Anchor Tenants:	Telus

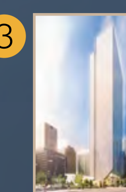
2



Brookfield Place Calgary - West

Landlord:	Brookfield Properties
Floors:	41
Building Area:	1,000,000 sf
Ave. Floor Plate:	27,500 sf
Est. Completion:	n/a
Anchor Tenants:	n/a

3

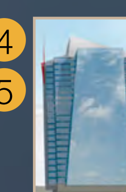


Oxford Tower

Landlord:	Oxford Properties
Floors:	47
Building Area:	1,200,000 sf
Ave. Floor Plate:	26,000 sf
Est. Completion:	n/a
Anchor Tenants:	n/a

4

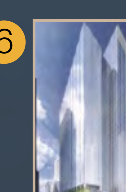
5



Palliser West and East

Landlord:	Aspen Properties
Floors:	29 each
Building Area:	620,000 sf each
Ave. Floor Plate:	23,500 sf
Est. Completion:	n/a
Anchor Tenants:	n/a

6



First Canadian Centre - East

Landlord:	GWL Realty Advisors
Floors:	27
Building Area:	698,000 sf
Ave. Floor Plate:	27,400 sf
Est. Completion:	n/a
Anchor Tenants:	n/a

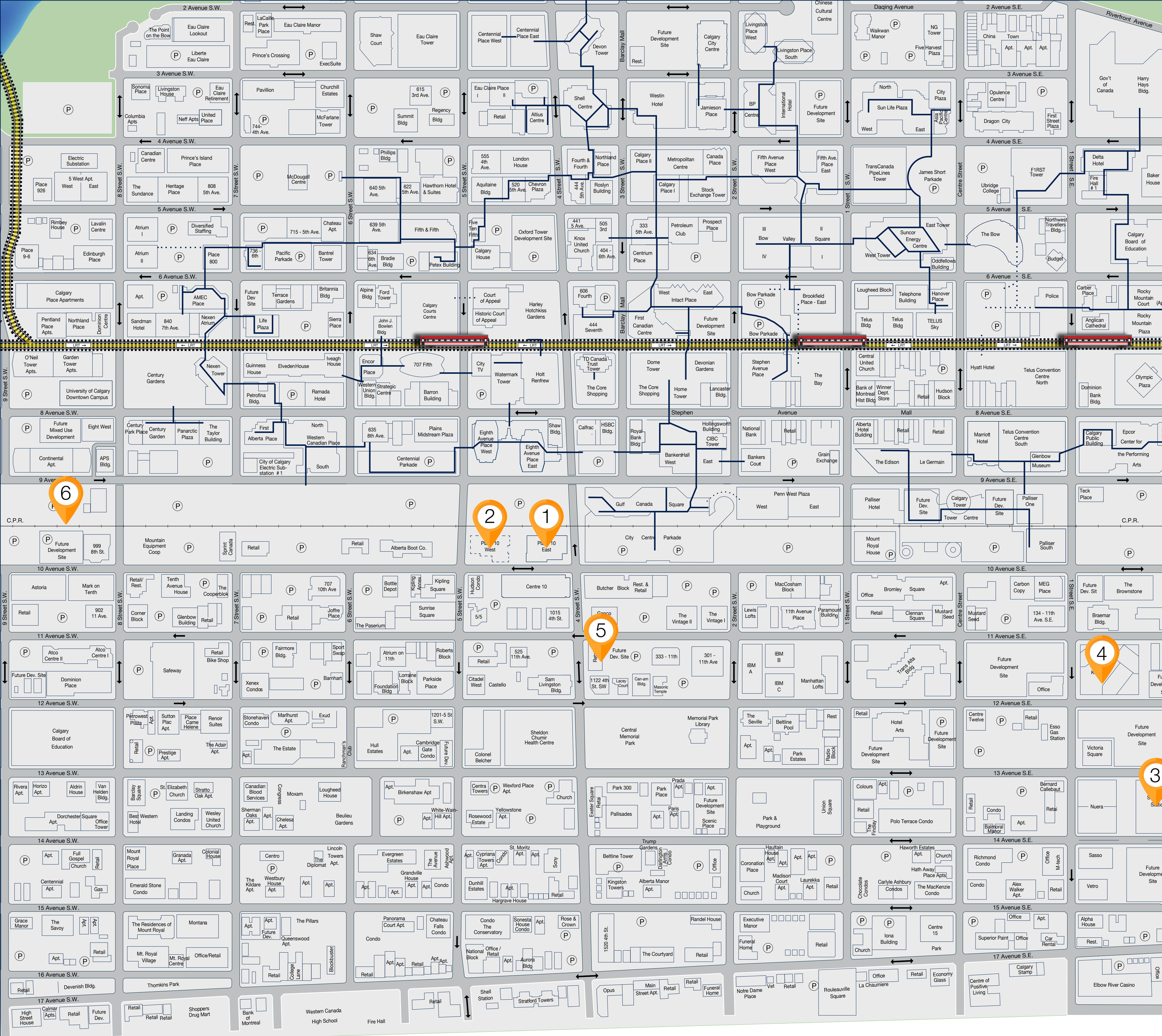
7

Eau Claire Market Redevelopment

Landlord:	Harvard Developments
Floors:	40
Building Area:	555,000 sf
Ave. Floor Plate:	13,800 sf
Est. Completion:	n/a
Anchor Tenants:	n/a

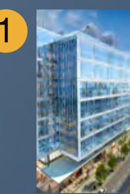
Anticipated Completion

2019 Pending



New DEVELOPMENTS
BELTLINE

1



Place 10 - East
Landlord: Centron Developments
Floors: 14
Building Area: 316,500 sf
Ave. Floor Plate: 24,850 sf
Est. Completion: 2017
Anchor Tenants: n/a

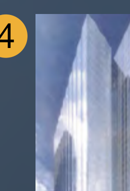
2

Place 10 - West
Landlord: Centron Developments
Floors: 14
Building Area: 300,000 sf
Ave. Floor Plate: 23,350 sf
Est. Completion: n/a
Anchor Tenants: n/a

3

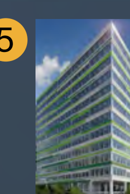
Stampede Station, Phase II
Landlord: Artis REIT
Floors: 19
Building Area: 315,400 sf
Ave. Floor Plate: 22,600 sf
Est. Completion: n/a
Anchor Tenants: n/a

4



Keynote 4
Landlord: Triovest Realty
Floors: 18
Building Area: 340,000 sf
Ave. Floor Plate: 20,900 sf
Est. Completion: n/a
Anchor Tenants: n/a

5



1108 - 4th Street SW
Landlord: Genco Development
Floors: 13
Building Area: 186,600 sf
Ave. Floor Plate: 15,400 sf
Est. Completion: n/a
Anchor Tenants: n/a

6

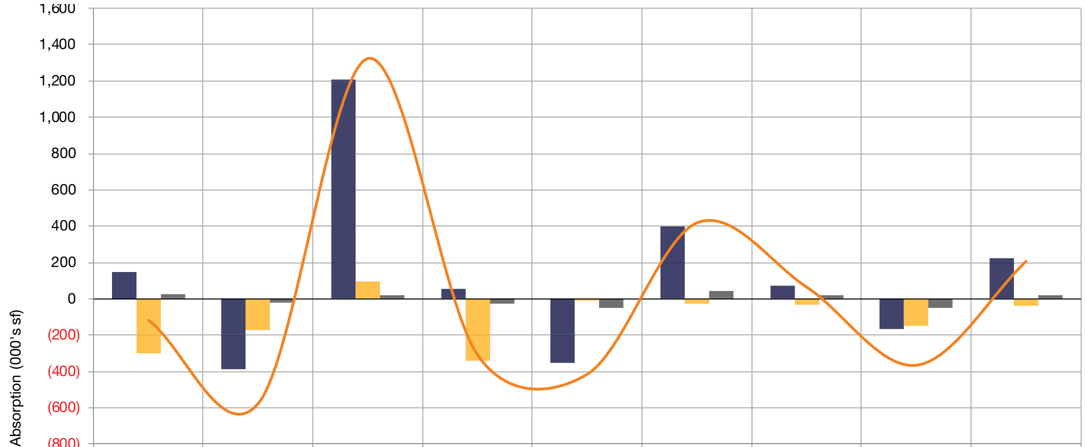
No rendering available

999, Phase II
Landlord: Triovest Realty
Floors: 13
Building Area: 224,000 sf
Ave. Floor Plate: 16,800 sf
Est. Completion: n/a
Anchor Tenants: n/a

Anticipated Completion
Pending

Graph FOUR

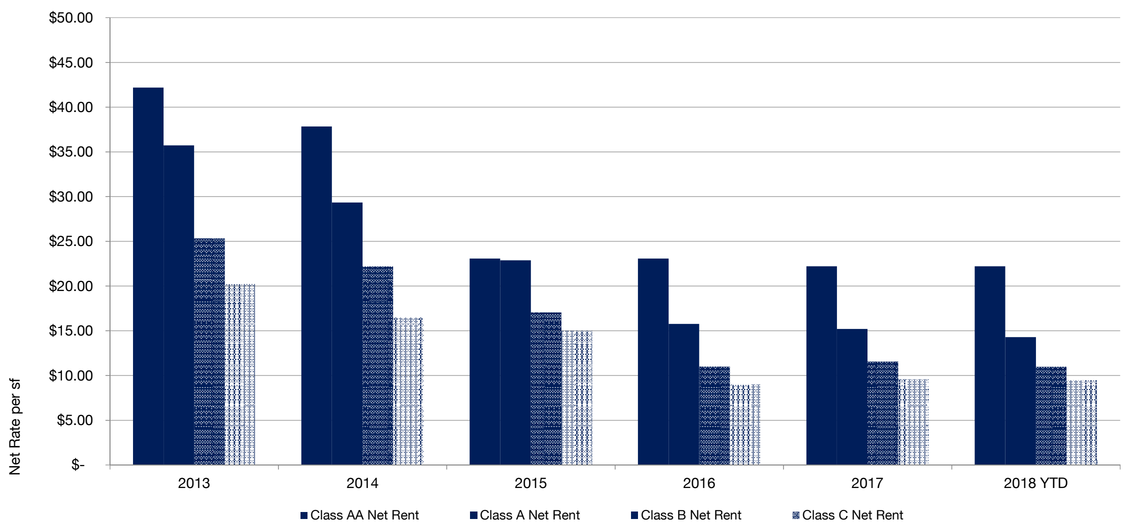
HISTORICAL DOWNTOWN OFFICE ABSORPTION



	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018
Class A/AA	150,619	(386,460)	1,208,884	53,141	(353,265)	397,059	72,310	(167,350)	224,141
Class B	(298,043)	(172,839)	92,659	(338,892)	(11,534)	(25,370)	(31,381)	(147,531)	(40,016)
Class C	26,658	(18,156)	21,133	(26,730)	(52,035)	45,431	21,461	(52,905)	20,843
Quarterly Absorption All Classes	(120,766)	(577,455)	1,322,676	(312,481)	(416,834)	417,120	62,390	(367,786)	204,968

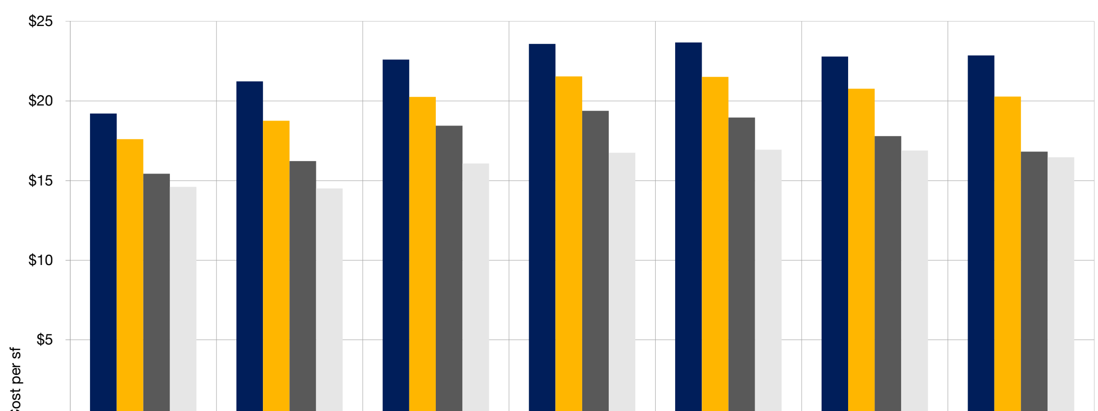
Graph FIVE

AVERAGE HEADLEASE NET RENTAL RATES PER SF, ALL CLASSES



Graph SIX

AVERAGE OPERATING COSTS PER SF



	2012	2013	2014	2015	2016	2017	2018
Class AA	$19.21	$21.23	$22.60	$23.58	$23.67	$22.79	$22.86
Class A	$17.60	$18.76	$20.25	$21.54	$21.51	$20.77	$20.27
Class B	$15.43	$16.22	$18.44	$19.38	$18.96	$17.79	$16.82
Class C	$14.60	$14.50	$16.07	$16.74	$16.94	$16.89	$16.46

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