POV

Point of View

Q2 2018

Downtown and Beltline Office Market Report

Market OVERVIEW

Downtown Market

Unless the function of an office as we know it is eliminated entirely, any commercial office market will never reach full vacancy. Despite advances in technology, artificial intelligence, and work structure, the presence of the office appears to be a very secure one. On the other hand, what is to stop a market from cratering to 30% vacancy? Or worse? Five years ago in Calgary, when office occupancy neared 97.5%, you would have been hard pressed to find anyone who foresaw a vacancy rate near 25% in the downtown core, but alas, here we are at the end of the second quarter of 2018 with a vacancy rate of 24.95%, having edged up 0.5% higher from the previous quarter.

Keeping such a dramatic swing in mind, we find ourselves asking: where is the bottom of the market and how will we be certain when we find it? In the first quarter, vacancy declined by a mere 0.14%. This quarter, it increased by an almost equally slim margin. With plenty of churn, but no meaningful growth, are the modest changes we have experienced thus far in 2018 an indication of what is in store for the rest of the year?

What we can say for certain is that there are signs the market is reaching the bottom. Without question, most of the bleeding has stopped; near the end of 2017, the downtown and fringe markets started to plateau, and that trend has become more obvious given the absorption numbers in the first half of 2018. Now the toughest two questions remain – where is “absolute zero” for vacancy, and what drives growth to start the steep climb out of the current environment?

One natural indicator of the low point of a market trough is the presence of large commercial transactions, or in this case, office towers changing ownership. Over the past two years, the following downtown and Beltline properties either changed hands (partially or fully), changed use (i.e. conversion to hotel or residential), or were put on the market for sale:

Table ONE

BUILDING TRANSACTIONS

Sale	
441 - 5 Avenue SW	Fourth & Fourth
622 - 5 Avenue SW	IBM Corporate Campus
840 - 7 Avenue SW	Joffre Place
1035 - 7 Avenue SW	Lavalin Building
Alpine Building	Life Plaza
Atrium I & II	McFarlane Tower
Centennial Place	Mount Royal Place
Dominion Centre	Northland Building
Eau Claire Place II	Prospect Place
Eau Claire Tower	Roslyn Building
F1RST Tower	Scotia Centre
Five Ten Fifth	TransCanada PipeLines Tower
Ford Tower	

Demolition	
Barclay Square	Sam Livingston Building

Re-Zoning/Proposed Re-Zoning	
630 - 4 Avenue SW	Sierra Place
Barron Building	Stephenson Building
Lougheed Building	

Market OVERVIEW

These transactions represent activity from several separate institutional holders of commercial real estate, including four entirely new entrants to the local market. It would seem to say that some landlords are viewing now as the time to enter the market, which is an indication of opportunistic mindsets and differing approaches with regards to the future of Calgary's office market.

Of the above list, five of these buildings (Sierra Place, 630 – 4 Avenue SW, Stephenson Building, Barron Building, and Lougheed Building) were slated for redevelopment or re-zoning, while two other buildings (Sam Livingston Building and Barclay Square) were scheduled for demolition. Re-zoning and demolition are, in our opinion, one of the strongest indicators that select landlords believe the market has bottomed out and will stay there for a very long time, as buildings that were difficult to lease for their existing landlords are being taken out of the vacancy equation entirely.

While some indicators are suggesting that Calgary is finally reaching a vacancy peak, others paint somewhat of a different story. Further consolidation amongst energy players, coupled with a significant balance of ghost space still floating around downtown, indicates that there is enough outstanding space to potentially step vacancy 1-3% higher from its current level. While signs may suggest we can see the bottom, it is hard to say if we are actually there, especially with respect to lower class product. The bleeding may have slowed, but that does not mean it has stopped entirely.

Looking at each market segment, we can draw the following conclusions from the second quarter of 2018:

AA Class – vacancy increased this quarter by a meager 23,918 square feet, bringing AA Class vacancy to 16.8%, which is the lowest of any class. Demand in this market segment remains the most active.

A Class – vacancy increased by 143,432 sf, hiking A Class vacancy an additional percentage point to 26.7%. Many tenants are upgrading to AA Class space and we expect this trend to continue driving vacancy higher in the A Class.

B Class – the B Class continues to lead all classes with respect to percentage vacancy, at 38.7%; it was the largest mover again this quarter, climbing by 147,531 sf, or approximately two percent. The previously mentioned flight to quality continues to punish the B Class market segment.

C Class – the C Class saw a rise in vacancy of 52,905 sf, which is somewhat of a misnomer, given that 158,400 sf of space was removed from C Class inventory after two buildings were re-zoned from office use; C Class vacancy sits at 24.65%.

Beltline and Fringe Markets

Beltline – Progressively edging closer and closer to downtown's vacancy rate, the Beltline is now 22.63% vacant. Many tenants, who moved to the Beltline from downtown in the last leasing cycle, are relocating back to the downtown core given there is little, if any, economic benefit to remaining in the Beltline. Given proposed re-zoning for the Stephenson Building, as well as the demolition of the Sam Livingston Building and Barclay Square, there are clear signs that landlords are concerned about the long-term vacancy outlook in the Beltline.

Kensington – One of the tightest markets in the city saw another quarter-to-quarter decline in vacancy. Kensington vacancy edged down to 9.63% from 10.09% in the second quarter.

Inglewood – Inglewood took the mantle this quarter as the lowest vacancy region in the city, as the vacancy rate plummeted over 5% to 8.14%. The drop can be credited to full leasing of the Dominion Bridge building.

Mission – Positioned near the Beltline, Mission still finds itself somewhat a victim of downtown's pull, and as such, saw its second quarter vacancy figures climb to 16.04% from Q1's 12.47%. As one moves further south down 4th Street SW, occupancy climbs as the demand for space gets higher.

Market FORECAST

It is never easy, or for that matter overly exciting, to forecast the market when the market itself is flat. Big swings – whether positive or negative – create a lot of interest for both the invested and casual reader. Be it the opportunity for arbitrage, or maybe the basic human habit of chasing drama, activity breeds interest. On the other hand, when the numbers are not changing, the story tends to require a nuanced approach.

The current market in downtown Calgary is one of nuance. While void of vacancy swings and moving rates, there are several phenomena in the local market worth paying attention to. As mentioned in the Market Overview, acquisitions, dispositions, and re-zonings are tangible changes within the commercial office sector, but there are indirect events that will impact the long-term market outlook as well.

The first notable trend in Q2 2018 was consolidation within Calgary's local energy industry. Following the merger of Tervita and Newalta earlier in the quarter, Vermilion Energy proceeded to acquire Spartan Energy, and Baytex Energy acquired Raging River Exploration. These three transactions, all of which were similarly sized and of reasonable complexity, broke a long drought of sizeable merger and acquisition activity in the city[1].

While the effects of these mergers are yet to fully unveil themselves, we can glean some information early in the process:

a) There is still room for additional consolidation in the energy industry, perhaps even on a scale well in excess of the above transactions;

b) Interest in Western Canadian assets appears to be primarily driven by local market participants, which is likely due to US and international entities having better investment opportunities abroad; and

c) Mid-cap companies are looking to diversify or bolster their asset bases.

Given the conclusions considered above, let us look at how energy industry consolidation may continue going forward and attempt to forecast what impact the mergers may make over the back half of 2018.

With each of the three abovementioned mergers, a locally operated entity purchased another local operated entity. For the sake of the office market, if there is any operational overlap at a corporate level – be it in auxiliary functions like accounting and human resources, or core functions like geology and engineering – personnel redundancies will open up desks. Those open desks should hit our vacancy figures, given that they create a volume of space, which, when coupled with existing pockets of "ghost" vacancy, equate to enough space to list independently. What may come as a bit of a saving grace with respect to these particular transactions, is that the asset overlaps between acquirer and the acquired are for the most part, limited.

Should similar transactions follow, expect further consolidation of office space. Realistically, future acquisitions may involve more obvious staffing redundancies, which would further bring space to market. Hypothetically, the opposite could happen if an entrant from outside of the province elected to acquire Western-Canadian based assets.

While office consolidation is a necessary outcome of M&A activity, we cannot ignore what is driving the change, as there is enthusiasm within Alberta's energy industry as it pertains to oil-weighted entities. New drilling activity in the Duvernay creates reason for optimism. Expanding oil sands operations should create project-based employment in downtown Calgary. Higher oil prices allow for new drilling activity in several existing plays and give companies a financial buffer. The combined impact of these activities should start to counter the impact of consolidation on our office market.

Looking outside of the energy industry, new activity in the city, largely driven through new entrants into the technology and cannabis sectors, will provide a positive – albeit smaller – bump to overall vacancy projections. Hard work from the City of Calgary and Calgary Economic Development is starting to pay off, as they are successfully encouraging new entities to test Calgary for their next development hub.

Maybe – just maybe – the bottom is near. While this is a market of nuance and we cannot say for sure that we have reached the bottom, from where we sit, the signs are starting to point towards a plateau in vacancy and eventual turnaround. Come the beginning of 2019, we hope we can point to a new trend of concrete positive absorption.

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[1] We acknowledge that Altagas purchased WGL Holdings at the start of 2018, but we do not expect the result of that transaction to impact Calgary's local office market in a material way.

Market FORECAST

Graph ONE

FORECASTED VACANCY

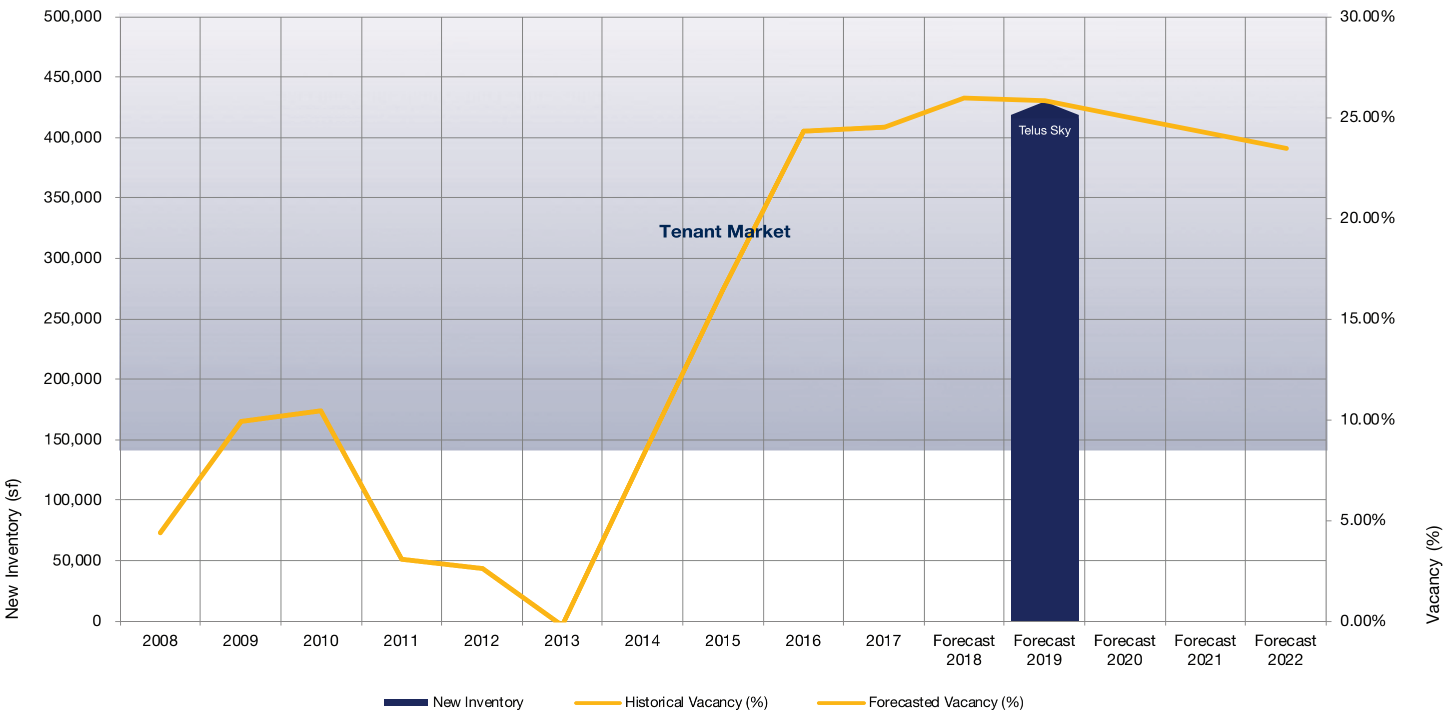


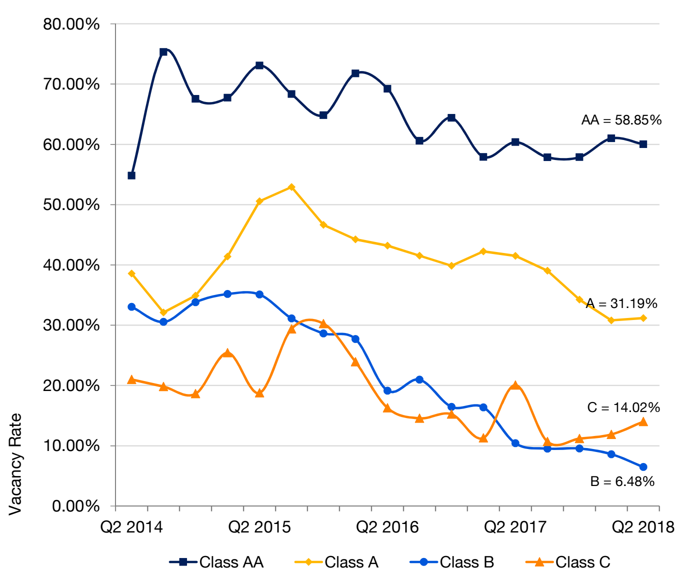
Table TWO

Q2 2018 VACANCY SUMMARY

BUILDING CLASS	TOTAL INVENTORY (sf)	HEADLEASE (sf)	HEADLEASE (%)	SUBLEASE (sf)	SUBLEASE (%)	TOTAL (sf)	TOTAL (%)
Downtown							
AA	15,960,873	1,056,839	6.62%	1,587,049	9.94%	2,643,888	16.56%
A	17,451,204	3,210,478	18.40%	1,453,888	8.33%	4,664,366	26.73%
AA/A	**33,412,077**	**4,267,317**	**12.77%**	**3,040,937**	**9.10%**	**7,308,254**	**21.87%**
B	7,529,304	2,725,654	36.20%	188,706	2.51%	2,914,360	38.71%
C	2,584,781	547,767	21.19%	89,308	3.46%	637,075	24.65%
Total Downtown	**43,526,162**	**7,540,738**	**17.32%**	**3,318,951**	**7.63%**	**10,859,689**	**24.95%**
Beltline and Fringe Area							
Beltline	6,986,799	1,039,025	14.87%	542,384	7.76%	1,581,409	22.63%
Kensington	604,702	52,336	8.65%	5,915	0.98%	58,251	9.63%
Inglewood	461,985	28,174	6.10%	9,427	2.04%	37,601	8.14%
Mission	917,600	147,185	16.04%	0	0.00%	147,185	16.04%
Total Beltline & Fringe Area	**8,971,086**	**1,266,720**	**14.12%**	**557,726**	**6.22%**	**1,824,446**	**20.34%**

Graph TWO

SUBLEASE VACANCY INDEX



Graph THREE

COMPARATIVE VACANCY

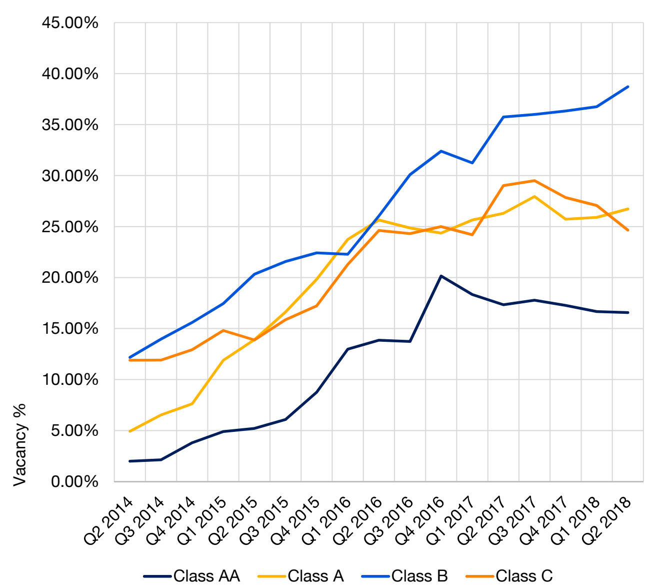
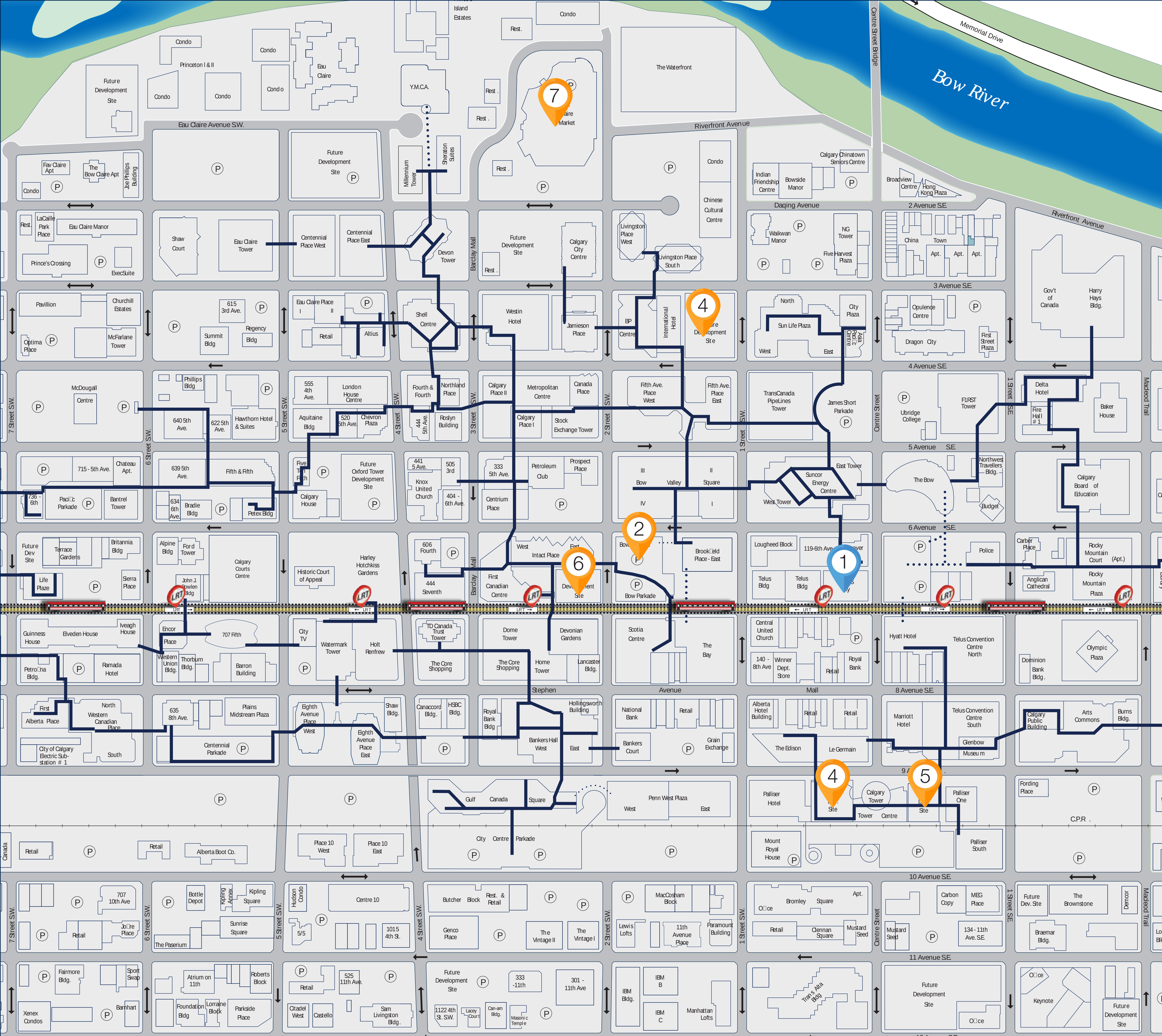


Table THREE

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	264,400
Penn West Plaza - East	Sublease	196,539
Gulf Canada Square	Sublease	193,604

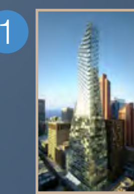
Building	Type	Area (sf)
F1RST TOWER	Headlease	177,352
Scotia Centre	Headlease	163,341
BP Centre	Headlease	134,796
Hanover Place	Headlease	126,211
Lavalin Centre	Headlease	119,366
The Edison	Headlease	118,826
The Bow	Sublease	116,165



New DEVELOPMENTS

DOWNTOWN

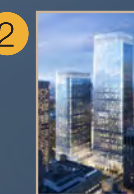
1



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

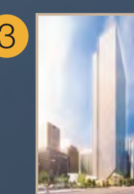
2



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

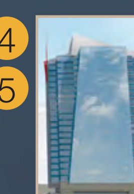
3



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

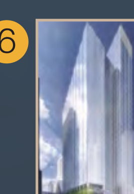
4 5



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

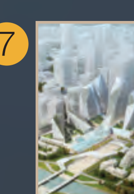
6



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

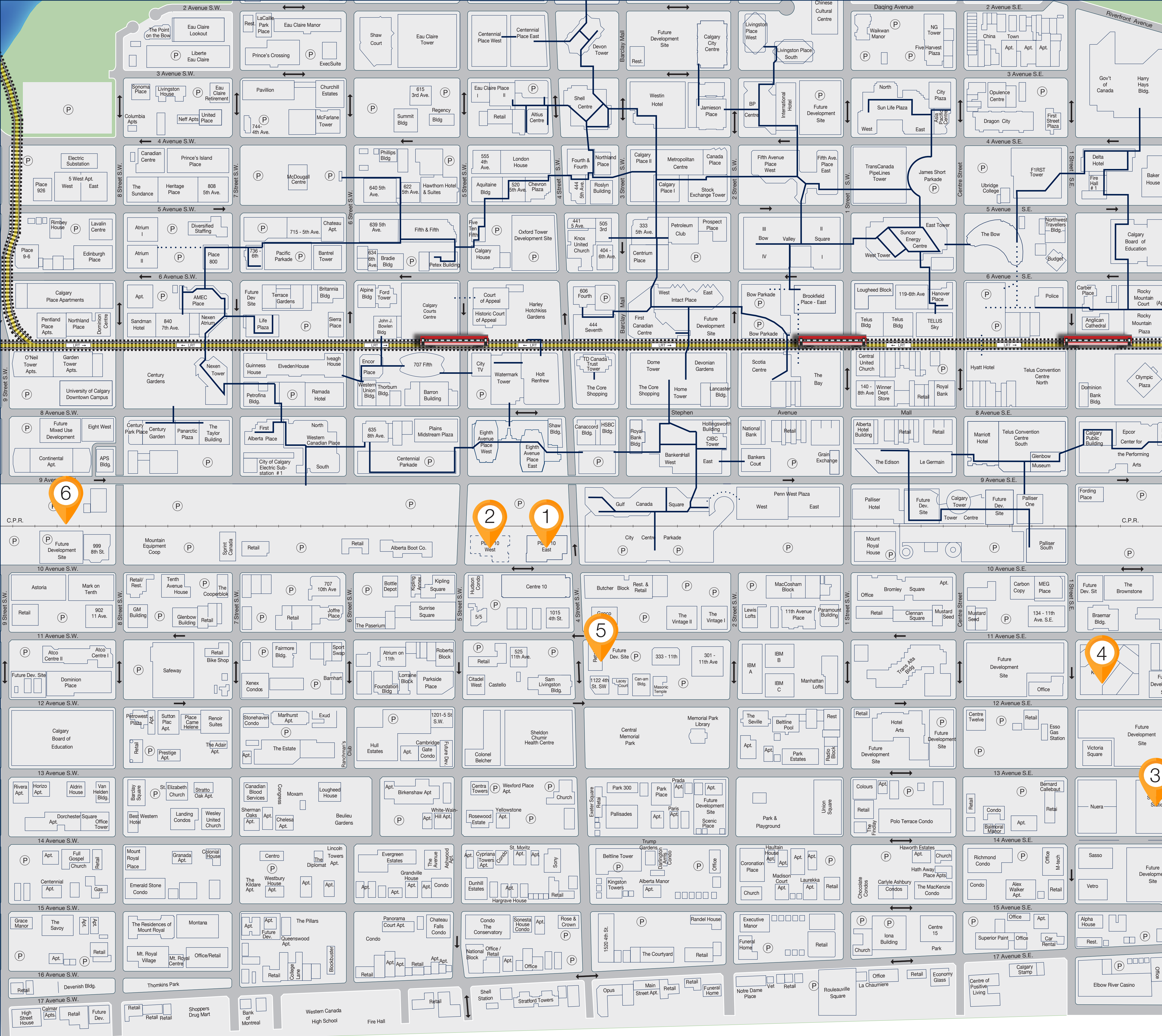


Eau Claire Market Redevelopment

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



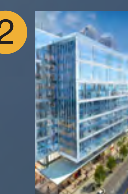
New DEVELOPMENTS
BELTLINE

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

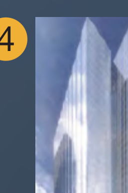
Landlord:	Centron Developments
Floors:	14
Building Area:	300,000 sf
Ave. Floor Plate:	23,350 sf
Est. Completion:	n/a
Anchor Tenants:	n/a

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

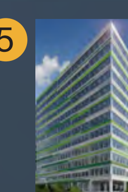
4



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

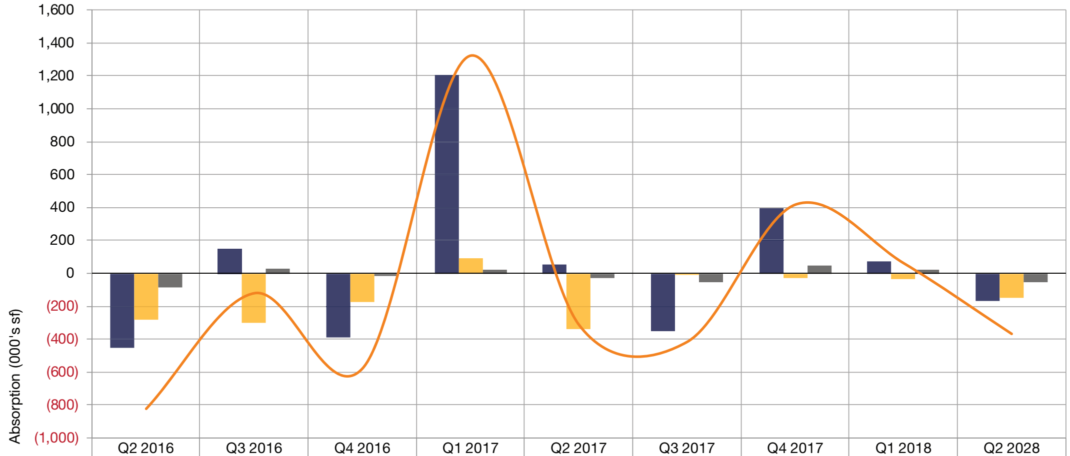
Landlord:	Triovest Realty
Floors:	13
Building Area:	224,000 sf
Ave. Floor Plate:	16,800 sf
Est. Completion:	n/a
Anchor Tenants:	n/a

Anticipated Completion

Pending

Graph FOUR

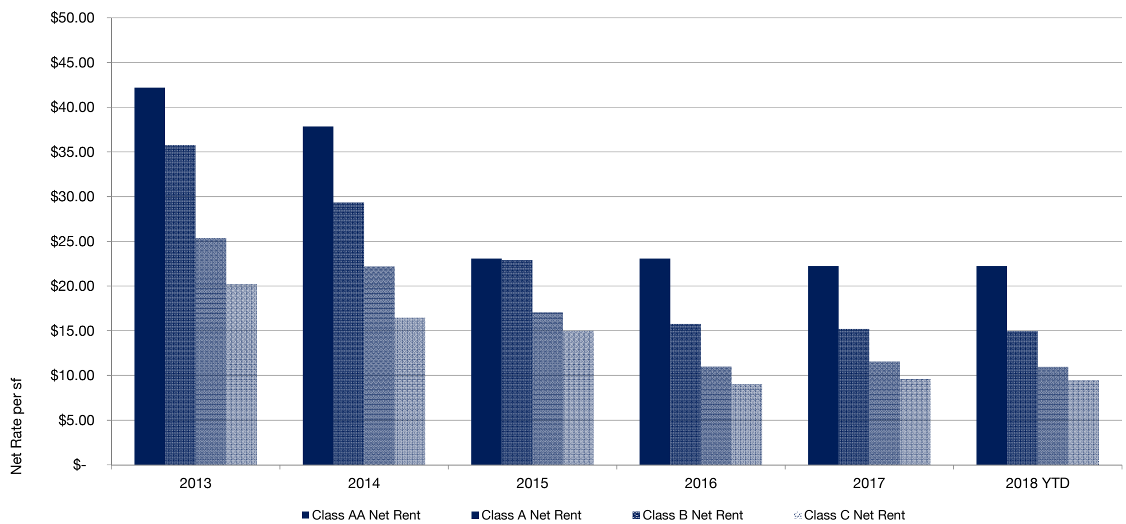
HISTORICAL DOWNTOWN OFFICE ABSORPTION



	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2028
Class A/AA	(451,937)	150,619	(386,460)	1,208,884	53,141	(353,265)	397,059	72,310	(167,350)
Class B	(282,819)	(298,043)	(172,839)	92,659	(338,892)	(11,534)	(25,370)	(31,381)	(147,531)
Class C	(88,211)	26,658	(18,156)	21,133	(26,730)	(52,035)	45,431	21,461	(52,905)
Quarterly Absorption All Classes	(822,967)	(120,766)	(577,455)	1,322,676	(312,481)	(416,834)	417,120	62,390	(367,786)

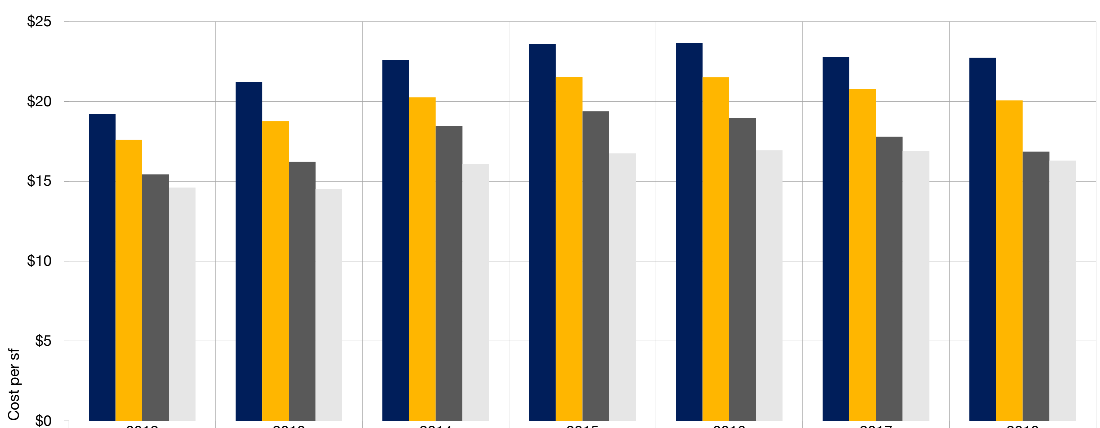
Graph FIVE

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	$22.74
Class A	$17.60	$18.76	$20.25	$21.54	$21.51	$20.77	$20.06
Class B	$15.43	$16.22	$18.44	$19.38	$18.96	$17.79	$16.86
Class C	$14.60	$14.50	$16.07	$16.74	$16.94	$16.89	$16.29

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