



ANDREW BARNICKE  
J.J. BARNICKE TORONTO

# INVESTMENT REPORT

## OVERVIEW

**2005** proved to be yet another strong year for property sales in Canada. New benchmarks were set in all property categories and the demand for all types of real estate continued to outstrip supply. With its strong economic performance, stable government, and solid real estate fundamentals, Canada is still seen by all international investors as a great place to invest. The increasing globalization of real estate benefited Canada in 2005, and will continue to benefit the country in the future.

There was a significant shift in the supply of new capital to the real estate market in 2005. International investors were the big story of 2004, with the largest purchasers being the German closed and open-ended funds. These investors took pricing to new levels and many suggested that these pricing levels would not hold. For 2005, domestic money sources took control of the buy side equation. Major pension funds that were new to the marketplace, and those that had been unsuccessful in acquiring assets due to increased foreign competition, returned actively to the market after realizing these prices were here to stay. At these new pricing levels, the German investors were essentially shut out from the buy side in most cases.

The debt and equity markets also provided plenty of fuel in 2005. For every dollar of equity there were three dollars of debt available. With stiff competition and lots of liquidity, lending rates remained low and spreads competitive. Even with an increasing interest rate environment, the demand for debt remains high and the impact to pricing has not been significant. With demand outstripping supply, most purchasers feel that even a 1.0% increase in interest rates will only translate into one-quarter to one-half percent adjustment in capitalization rates.

Throughout 2005 investor preferences changed. Almost all product categories saw a marked increase in demand with buyers outnumbering sellers in most cases. There was also a notable increased interest in hotels and regional malls. Combining the broadening of buyer preferences and product type, there was also a significant increase in demand for properties in secondary markets. The hottest markets in the country remain Montreal, Ottawa, Greater Toronto Area, Calgary, Edmonton, and Vancouver, with Calgary turning in the hottest performance in the second half of 2005. However, new players have come to the table in the way of new REITs, pooled funds, and private equity groups, and are focusing their efforts primarily on secondary markets. This is adding a great boost to these local real estate communities as investors are seeking better going-in yields and better near term upside. Users wanting to escape the high occupancy costs of major metropolitan areas such as Toronto and Calgary are also driving the demand for secondary market product. With increased interest, markets like Kanata, Barrie, Brantford, Kitchener/Waterloo, and Edmonton have all seen demand increase significantly for real estate opportunities.

The residential market was also an important driver in 2005. Residential building permits for the last four years have significantly outpaced

the development of commercial properties. The demand for residential land in Ontario and Alberta has been significantly impacted by government activity such as the introduction of the Greenbelt Plan in Ontario and increased economic activity associated with Alberta. Increased high-rise residential condominium development has also been a key driver in several markets. Once a product specific to Vancouver and Toronto, high density residential is now being built across the country. It is also becoming a key driver in the revitalization of downtown cores in secondary communities. Toronto and Vancouver continue to lead the country not only in volume, but also in pricing, although strong high-rise residential markets are in play all across the country including Halifax, Montreal, Ottawa, Winnipeg, Calgary, and Edmonton.

One of the largest residential land transactions in 2005 was the sale of a land parcel at Bay Street and Scollard Street in the Yorkville node of Toronto by AMTOCA Investment Limited to 2048098 Ontario Inc. for \$45.0 million. The purchaser has since submitted a proposal for a mixed-use development consisting of two buildings, a 55-storey hotel-residential tower and a 30-storey residential tower. Four Seasons Hotels and Resorts will operate the hotel-residential tower.

## OFFICE

The demand for office product in 2005 remained strong; although with limited supply available, the number of transactions on a single asset basis was not as significant as was recorded in 2004. The large owners, who have been culling their portfolios for the last couple of years, are effectively at the end of these mandates. The ability to buy existing office product in the country will continue to be limited throughout 2006.

The lack of any significant new construction supply over the last couple of years has slowly changed the economics of most office markets in the country. With increasing occupancy levels, there is some evidence of landlords beginning to increase rates and decrease inducements. Rental rates in general are still below replacement cost levels, with the exception being the Calgary marketplace where the chronic shortage of available space is driving rental rates to record highs for that market.

Even though new benchmarks are evolving in office valuation across the country, the fundamental outlook for office ownership looks positive. Vacancy rates are declining, rental rates are increasing, and pricing is still below replacement cost. Even with potential increases in borrowing costs, rental rate increases should more than compensate.

The major deal of 2005 was the sale of a 50.0% interest in 11 Class A assets comprising 8.1 million square feet by OMERS/Oxford to CPP Investment Board ("CPPIB") with an estimated transaction value in excess of \$1.0 billion. This was followed up closely with the acquisition of O&Y Properties and O&Y REIT by a consortium led by Brookfield, CPPIB and Alberta Revenue with an estimated transaction value in excess of \$2.0 billion.



## INDUSTRIAL

After regional retail, industrial is the number one product of choice of every major institution in the country. Funds attempting to balance their portfolios along product and market lines had difficulty finding enough product to meet their demand in 2005. All industrial markets in the country have strong fundamentals and, with limited speculative development, occupancy levels were at an all time high putting upward pressure on rental rates. Demand for industrial income properties has begun to push speculative development, which is impacting the value of industrial land. The merchant builder has stepped in to satisfy the demand of hungry investors, as many of the large existing owners of industrial portfolios are unwilling to part with properties at this time.

A handful of developers such as Giffels, Opus Corporation, Panattoni Canada Inc., and Higgins Development Partners have all teamed up with institutional money to build speculative industrial product at better yields than what existing product can be purchased at today.

The benchmark deal of the year was the sale of the Erin Mills Portfolio to Ontario Pension Board ("OPB"). The sale of this \$336.0 million, 2.9 million square foot portfolio, was hotly contested. Ontario Pension Board was also the winning bid in another significant industrial portfolio in 2005, a 600,000 square foot portfolio from Roycom Realty and its investors in Halifax. Also of significance in 2005 was the sale of Menkes Developments' GTA office and industrial portfolio consisting of 4.5 million square feet of industrial properties and half a million square feet of office buildings worth a total of approximately \$447.4 million.

One of the largest single asset transactions in 2005 in the Greater Toronto Area was the sale of 1400 Church Street in Pickering by Panattoni Canada Inc. and Pickering Church Street Limited Partnership to H & R REIT for \$58.0 million or \$81 per square foot at a capitalization rate of 7.2%.

## RETAIL

Tier One Regional Malls remain the number one product of choice for all buyers. However, with the lack of available opportunities, and high demand, most investors have had to settle for other asset opportunities. Retail continues to grow in popularity as a product class. Availability of product has improved and many investors, who had previously avoided this product class because they perceived it as being too specialized, have increased their comfort level and are now looking to acquire. In addition, passive investors are getting better advice as industry experts improve their ability to service this class of asset.

The entry of new retailers and retail formats has breathed new life into shopping centres, increasing their attractiveness to investors. Names such as H & M, Lowe's, Zara, Best Buy, Mango, and Whole Foods, to name just a few, are giving landlords more options to choose from. Consumer spending continues to be strong and sales growth in most

shopping centres has been positive. Retail development remains steady, with anywhere from 10 to 15 million square feet of new retail space being constructed each year. One cause for caution is what the future holds for large format department stores. These continue to struggle in the ever-increasing competitive environment of the value conscious consumer in Canada. Typically these large format retailers own or lease significant amounts of retail and their real estate decisions will have an impact on the business going forward.

The major portfolio deals of the year saw Calloway REIT continue to acquire Wal-Mart anchored shopping centres from First Professional. In 2005, Calloway acquired 35 operating shopping centres and 10 parcels of development land for a total value of \$1.2 billion. Another large transaction in 2005 was the acquisition of an 80.0% interest in two properties by CPPIB from Iberville Corp. The Galeries de la Capitale in Ste. Foy and Carrefour de L'Estrie in Sherbrooke represented a total of 2.7 million square feet, and represent some of Canada's best regional retail. Other noteworthy portfolios included RioCan's purchase of three shopping centres in Quebec, and Delek Belron International's purchase of 30 strip malls across the provinces of Quebec and Ontario.

## INVESTMENT FORECAST

There are no signs on the horizon that the demand for real estate is going to soften significantly during 2006. Unlike our neighbours to the south, very few markets in Canada had a significant, speculative building boom over the past three years. Because of this cautious supply delivery, occupancy levels have remained acceptable and, as the economy continues to grow, we will continue to see a shift from a tenant's market to a landlord's market. Increasing rental rates will begin to spur new development in the major markets with Calgary and Toronto leading the way. Canada will continue to be the beneficiary of capital from both domestic sources and international sources. As we move through 2006 and into 2007, Canada's largest institutional players will begin to move significant money out of Canada and into Europe, the United Kingdom, and the United States.



NEWPORTCENTER, WINNIPEG, MANITOBA

