SUBLET VACANCY IN CANADA'S OFFICE MARKETS:

FORECASTING A RETURN TO BALANCE

GWL REALTY ADVISORS

The purpose of this report is to provide an addendum to GWL Realty Advisors' most recent Research Report entitled *Sublet Vacancy in Canada's Office Markets: Forecasting a Return to Balance* (No. 4, April 2003)[1]. The focus of this addendum will be on the Edmonton office market, which will be analyzed in a similar fashion as Montreal, Ottawa, Toronto, Calgary and Vancouver were analyzed in the original report.

Edmonton was omitted from the original report due to the relatively small size of its office market; Edmonton's total office inventory of 18,278,746 square feet is significantly smaller than the inventories of the five major markets analyzed in the original report (Ottawa was the smallest of the five with a total inventory of 32,755,553 sf). However, many of our readers were curious to know whether a market with a smaller inventory would help to insulate a national portfolio from the "sublet effect" identified in the original report. The intent of this study was to perform the same analysis of the Edmonton office market as we did for the five largest markets in order to determine if Edmonton mirrored the national trend and to discuss the probable reasons for the outcome.

This update should be viewed as a direct supplement to the original report as all subsections and data tables presented herein correspond with the subsections and tables in the original report (as indicated in parentheses).

THE GROWTH OF OFFICE SUBLET VACANCY

Table 1 (corresponds with Table 1 in original report) shows sublet vacancy as a proportion of overall vacancy in Edmonton. As can be seen in this table, sublet vacancy only accounts for 11.7% of the City's overall vacancy. This proportion is lower than each of the five largest markets (Montreal's proportion was 13.2% while Ottawa registered the highest proportion at 55.0% and the weighted average of the five was 22.9%). On a submarket basis, it appears that sublet vacancies are having a somewhat greater impact on Edmonton's Downtown submarket versus the suburbs. Of the five major markets, only Suburban Montreal, at 8.4%, had a lower proportionate sublet vacancy than Downtown Edmonton. Suburban Edmonton has the lowest proportion of all the submarkets, at 5.0%. Furthermore, no consistent trend between the proportionate sublet vacancies between Downtown and Suburban submarkets appeared to exist (i.e., some cities had higher proportions in the Suburbs while others were higher Downtown).

TABLE 1:
CHARACTERISTICS OF EDMONTON'S OFFICE MARKET, December 31, 2002

CMA	Total Office Inventory (sf)	Overall Vacancy sf	Overall Vacancy %	Sublet Space (sf)	Sublet sf as % of Overall Vacant sf
Edmonton	**18,278,746**	**2,175,088**	**11.9%**	**254,278**	**11.7%**
Downtown	*13,028,188*	*1,650,314*	*12.7%*	*227,965*	*13.8%*
Suburban	*5,250,558*	*524,774*	*10.0%*	*26,313*	*5.0%*

Source: Royal LePage Commercial Inc.

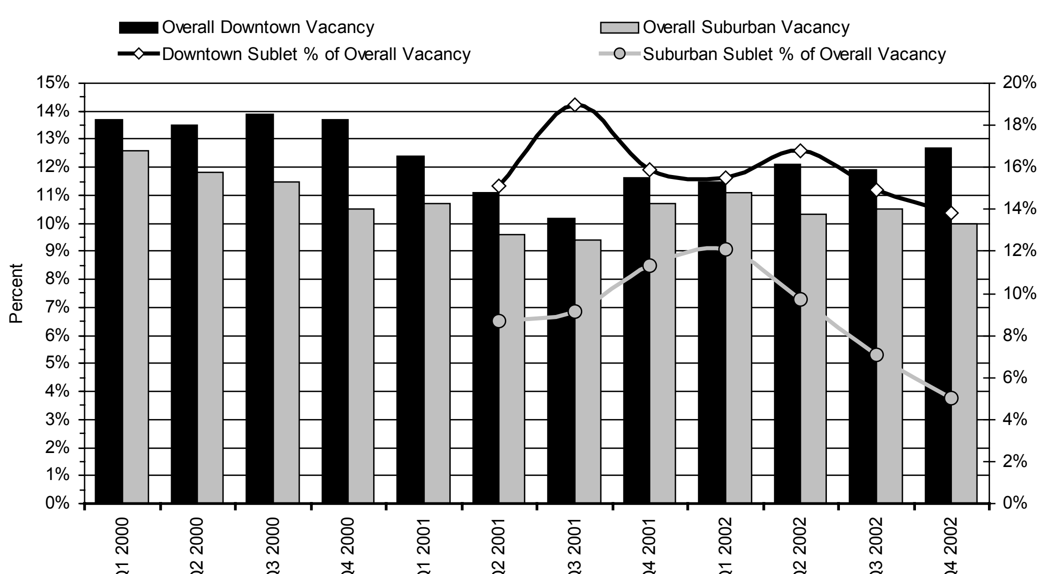
[1] The original report may be found at www.gwlra.com . Click on "About Us" and then "Publications".

It should be noted that approximately 110,000 sf of Edmonton's total sublet vacancy is comprised of a single opportunity at Telus Plaza North located in the Downtown core. Late last year, Telus exercised its option to give back this space to the landlord, effective January 2004; in the meantime, the vacancy remains on the sublet market. The data in Table 1 suggests that the Telus sublet opportunity represents 50% of the Downtown submarket's total vacancy, and thus should be considered an anomaly in the marketplace.

One common experience amongst the five major markets was that, despite the fact that overall vacancy has been on the rise since the beginning of 2002, the rate of sublet vacancy has been growing at an even faster pace. Looking at Figure 1 below (corresponds with Figure 2 in original report), and comparing it against the chart for the five major markets, several differences between the Edmonton market and the five major markets become evident:

- Edmonton's vacancy rate in the Downtown submarket is consistently higher than the vacancy rate in the Suburbs. The opposite is true for the five major markets;
- Although Edmonton's vacancy rates have been declining in recent years, the Q3 2001 overall vacancy rate of 9.9% is the lowest level reached by this market in almost 15 years; as such, no significant new inventory has been constructed in a number of years. By contrast, all of the five major markets' vacancy rates have experienced spurts of absorption sending vacancy rates low enough to prompt significant new development;
- Edmonton's overall vacancy rate continued to decline until as recently as Q4 2001 and has only risen modestly since then (in fact, the rate has been in decline over the past year in the Suburbs). On average, the five major markets have been experiencing climbing vacancy rates since Q1 2001; and
- Sublet vacancy as a proportion of overall vacancy in Edmonton has generally been in decline since Q1 2002. Conversely, in the five major markets, the rate of growth of proportionate sublet vacancy may have slowed recently, but has been flat or rising since Q3 2001.

FIGURE 1:
DOWNTOWN AND SUBURBAN SUBLET vs. OVERALL VACANCY - EDMONTON, Q1 2000 - Q4 2002



Source: Royal LePage Commercial Inc.
Note: Royal LePage did not track sublet vacancies separate from headlease vacancies prior to Q2 2001.

At the time of publication of this addendum, Royal LePage's Q1 2003 office market survey statistics were available for review, and the following trends are noted below:

- Negative absorption of approximately 24,000 sf in the Downtown submarket marks the third consecutive quarter of negative absorption; however, the magnitude of negative absorption has been decreasing with each consecutive quarter;
- In the Suburbs, negative absorption of approximately 11,000 sf follows a quarter during which over 27,000 sf of positive absorption was experienced;
- Sublet vacancies in both submarkets declined over the quarter; approximately 18,000 sf of sublet vacancy was absorbed in the Downtown submarket, while the Suburbs recorded a modest decline of less than 1,000 sf;
- Conversely, direct vacancies in both submarkets increased by notable amounts (42,000 sf in Downtown, 12,000 sf in Suburbs);
- As such, vacancy rates edged up slightly in both the Downtown (from 12.7% to 12.9%) and Suburban (from 9.5% to 9.6%) submarkets, raising the overall vacancy rate by 10 basis points to 12.0%; and
- The overall impact is that in both submarkets, sublet vacancies as a proportion of overall vacancies declined during the first quarter of 2003 (12.5% in Downtown, 4.8% in Suburbs, 10.7% overall).

Another common experience amongst the five major markets was that overall sublet vacancy was more prevalent in Class 'A' office buildings than in Class 'B' and 'C' buildings (except for Calgary where the total volume of sublet space was slightly higher in 'B' and 'C' buildings than in Class 'A' properties). There was less consistency amongst the cities when further analyzing this pattern in terms of Downtown versus Suburbs. In Edmonton, as is evidenced in Table 2 (corresponds with Table 2 in original report), the trend holds true with close to 90% of the City's sublet vacancy being available in Class 'A' buildings.

TABLE 2:
CLASS 'A' vs. CLASS 'B/C' SUBLET VACANCY, December 31, 2002

	Sublet Vacancy		
CMA	Class 'A' (sf)	Class 'B/C' (sf)	Total
Edmonton	**224,109**	**30,169**	**254,278**
Downtown	*205,411*	*22,554*	*227,965*
Suburban	*18,698*	*7,615*	*26,313*

Source: Royal LePage Commercial Inc.

ESTIMATING THE TIMING AND SIZE OF AN OFFICE MARKET RECOVERY

The original report on the five major markets included an analytical model to forecast how long it could take for each city to absorb its "oversupply" of vacant sublet space. This model was based on the premise that a 10% proportion of sublet vacancy versus overall vacancy was considered to be within a reasonable and healthy range. The magnitude of oversupply impact was measured by first calculating the volume of sublet vacancy that was over and above 10% of total vacancy. Next, the analysis applied the City's historic 12-year average absorption against the oversupply in order to determine a length of time required to absorb the excess, as a measure of total impact that could be equally compared on a market-by-market basis.

Using this same methodology, Table 3 (corresponds with Table 4 in original report) illustrates the impact of the sublet vacancy oversupply that exists in Edmonton.

TABLE 3:
ESTIMATE OF EDMONTON'S SUBLET ABSORPTION REQUIRED TO REACH 10% OF OVERALL VACANCY BASED ON HISTORICAL AVERAGE ANNUAL ABSORPTION, Starting January 1, 2003

Market	At December 31, 2002 Total Vacant Space (sf)	At December 31, 2002 Total Sublet Space (sf)	At December 31, 2002 Sublet % of Vacant	Sublet Absorption Required to Reach 10% of Total Vacancy (sf)	Average Annual Absorption 1990-2002 (sf)	**Estimated Time Required in Months***
Downtown	*1,650,314*	*227,965*	*13.8%*	*62,934*	*46,855*	***16***
Suburban	*524,774*	*26,313*	*5.0%*	*-*	*72,612*	***-***

* Based on average annual absorption from 1990 to 2002 inclusive.

Analysis assumes current vacancy remains constant and does not factor the impact of new supply, nor changes in direct and sublet vacancy, which will impact the time required for recovery.

Source: Office market data from Royal LePage Commercial Inc.; calculations and analysis by GWL Realty Advisors Inc.

As can be seen in Table 3, only Edmonton's Downtown submarket is experiencing a sublet vacancy oversupply problem; the suburban proportion is below 10%. Given the Downtown submarket's 12-year average annual absorption rate of 46,855 square feet, we estimate that 16 months' worth of oversupply currently exists in the market.

Sublet vacancy oversupply appears to have a lesser impact in the following submarkets than in Downtown Edmonton (number of months' worth of oversupply in parentheses):

- Downtown Montreal (15)
- Suburban Montreal (0)
- Suburban Toronto (8)
- Suburban Calgary (6)
- Downtown Vancouver (11)
- Suburban Vancouver (2)

On the surface, although Edmonton appears to have a very mild case of the "sublet phenomenon", (i.e., only 11.7% ratio of sublet versus overall vacancy), the City's relatively weak historical absorption increases the length of time it would take to return sublet vacancy to healthy levels. Therefore, in reality, the sublet vacancy phenomenon does have a significant impact on Edmonton's office markets and will likely continue for the next several months.

ADDITIONAL COMMENTS AND OBSERVATIONS

In summary, the volume of sublet vacancy in the Edmonton market is considered to be within healthy levels when viewed as a proportion of overall vacancy. However, the historically lukewarm absorption levels point to a shortcoming of the City's capacity and capability to effectively handle its oversupply. An understanding of the composition of Edmonton's office tenant base helps to explain the reason for this dichotomy.

Edmonton represents the Provincial seat of government in Alberta; the Federal and Municipal Governments also have a large presence in the office market. As such, government departments (all levels), related agencies, healthcare and education form the largest office tenant segment in the City. In fact, Edmonton's Downtown core is divided into two distinct districts: the Financial Core and the Government District. The bulk of the City's sublet vacancy is available in the Financial Core, with Telus' 110,000 sf sublet offering at Telus Plaza representing the lion's share of the total. Government tenants are rarely lessees or lessors of sublet space as the terms and conditions of government tenancies usually have quite specific requirements. The result is that the market relies solely on the private sector tenant base to absorb any sublet vacancies.

Edmonton's private sector, office tenant base is comprised primarily of companies in the natural resources, technology and financial sectors. The largest employer in Edmonton, by a wide margin, is the Telus Corporation (over 5,000 employees as of June 2002). Aside from Telus, there are only a few office tenants who employ more than 1,000 people (e.g., ATCO, EPCOR, Stantec); Edmonton's office tenant base is dominated by smaller-sized companies who do not occupy large premises. Conversations with local market agents suggest that up to 80% of all leasing activity in Downtown Edmonton is comprised of leases of less than 3,000 sf.

The tenant composition of the Edmonton market is the greatest reason for the City's sublet dichotomy. Because of the relatively small size of the majority of Edmonton's office tenants, the risk of having large blocks of space simultaneously becoming available for sublet is relatively less than compared to other markets that are dominated by large tenancies (i.e., Calgary, Toronto, Montreal). However, when a large sublet vacancy does become available, as is currently the case at Telus Plaza, there are few tenants who have the capacity to absorb such large blocks in a relatively short period of time.

It should be mentioned that, for two main reasons, the local real estate community does not consider the sublet opportunity at Telus Plaza to be competitive with the rest of the sublet market. Firstly, the absolute size of the availability and lack of willingness on the part of the sublandlord to break the space into multi-tenant premises leaves the opportunity open to only a handful of large, government requirements. Secondly, the Telus sublet opportunity expires in January 2004, which effectively makes this space a headlease opportunity. At the time of this publication, there were three large government requirements ranging from 14,000 sf to 30,000 sf exploring the market for new leases commencing in 2004/2005, and Telus Plaza is considered to be one of the few options available. With regard to this particular analysis, the reversion of this space from sublet to direct space at the end of this year will surely eliminate Edmonton's sublet oversupply problem.

Recent market activity experienced during Q1 2003 points to the two factors that ultimately create a positive impact on proportionate sublet vacancy – absorption of sublet vacancy and increases in direct vacancy. In light of the latter factor, we contemplate whether the Edmonton market will be any "healthier" in terms of overall vacancy once the Telus sublet reverts to direct vacancy given the City's historically limited capacity to absorb excess space. However, we note that the composition of Edmonton's tenant base helps to protect the market from sizable swings in vacancy. As well, the market's mechanics indicate that the City will not experience any significant increases in inventory for many years to come. The overall effect is that Edmonton's office market is currently stable, more predictable, and perhaps better insulated from market phenomena, than the larger office markets in Canada.