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SPECIAL REPORT

A NEW ERA IN INDUSTRIAL REAL ESTATE

A Cushman & Wakefield Research Publication

Bright Spot in Commercial Real Estate

Canada's major industrial real estate markets shifted gears in 2015, accelerating from average to record performance. The momentum is expected to continue through 2016, notably, in Vancouver, Toronto, and Montreal. In 2014, Canadian industrial absorption reached 10.6 million square feet (msf); by 2015 it had topped 17.8 msf — a high not seen since 2005. All major markets contributed to this impressive result, including, surprisingly, Calgary and Edmonton.

The shift in industrial real estate momentum seems almost counter-intuitive, given how hard office real estate has been hit by sustained low commodity prices and volatile economic conditions. Outside of downtown Toronto, expansionary momentum in most office markets has slowed to a snail's pace since the financial recession. Of course, the oil price shock was the knock-out punch for Calgary, which saw an unprecedented 2.6 msf vacated by retrenching companies between June 2014 and December 2015.

Industrial markets, on the other hand, have experienced explosive expansionary momentum and shrinking vacancy, particularly in energy-consuming regions with strong export ties to U.S. markets. Demand for industrial space, fueled by low energy prices, rock-bottom interest rates, and robust U.S. demand for Canadian goods and services was the unexpected story of 2015. Another game-changing factor has been the evolution of e-commerce, driving the need for well-located, designed, and automated warehouse and distribution centres close to major Canadian urban centres.

> Institutional buyers and prospective owner occupiers are faced with a shortage of well-located, quality industrial product, in what has become one of the hottest markets since the financial crisis

A New Era: Dynamics of Change

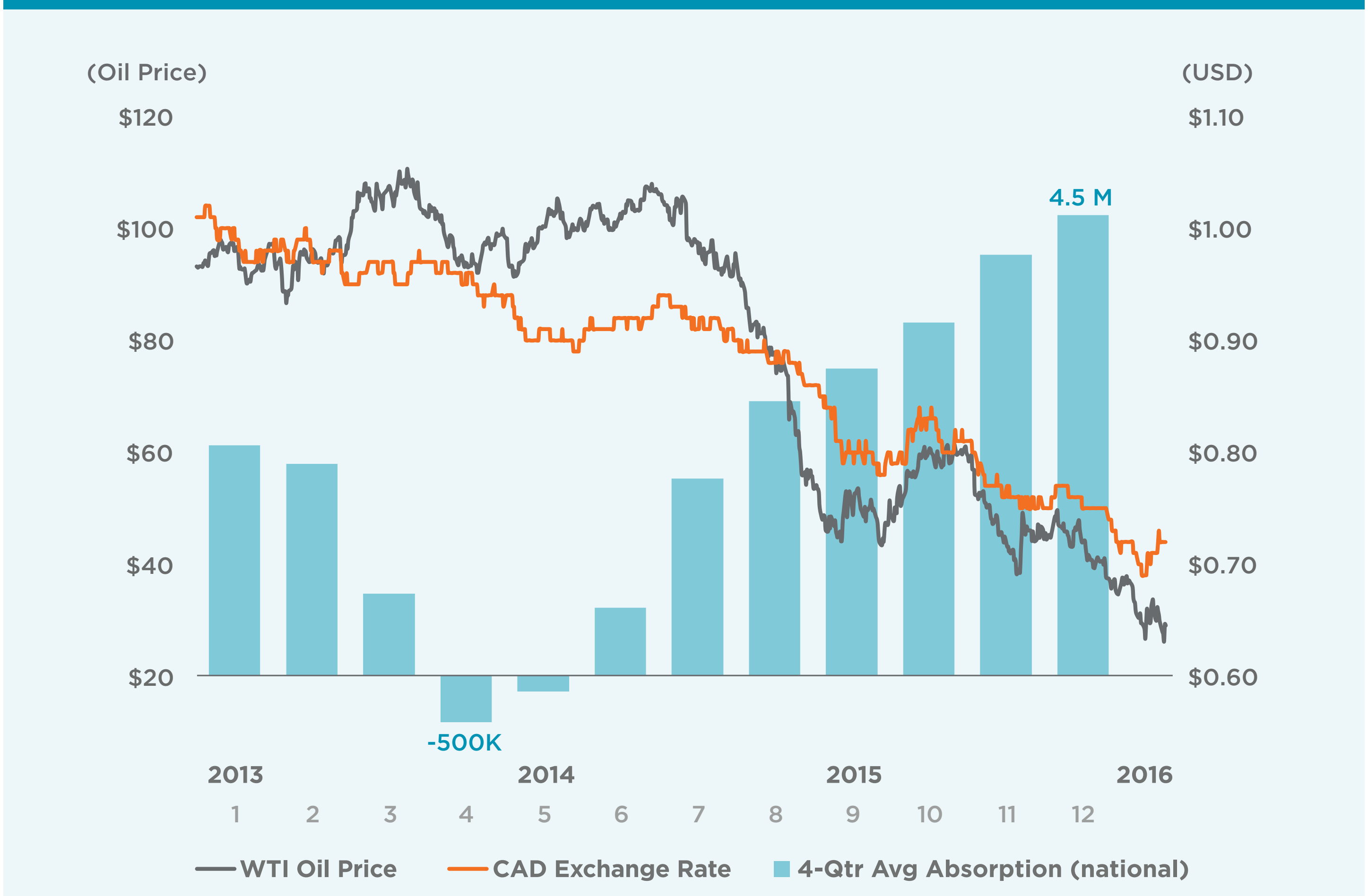
- Low energy costs, a more competitive dollar, and a strong U.S. economy are some of the key factors causing Canada's industrial markets to accelerate at the fastest pace in more than a decade.
- E-commerce is driving demand for larger warehouse and distribution facilities (especially in Canadian markets adjacent to populated U.S. centres) that are well located and automated to support streamlined logistics, including just-in-time delivery to store locations and individual customers.
- Strong U.S. demand is fueling export markets and motivating companies to strategically position themselves to deliver product to market at record speed.

  As outlined in Scotiabank's *Global Economic Update*, March 2, 2016: "B.C. and the central provinces are collectively benefitting from much more diversified economies in manufacturing, services, retail/wholesale activity, and residential construction, in addition to non-energy resources. Over the past year, for example, export volumes in consumer goods, industrial machinery, electronics equipment and aircraft & parts expanded at 6.9%, 6.1%, 4.3% and 2.6%, respectively."
- Manufacturing sales rose to the highest level on record in January as shipments of motor vehicles, food, and car parts surged. Stats Canada reported that Canadian factories sold $53.1 billion worth of goods in January.

  Regionally, eight provinces recorded increased sales in January, led by Ontario and Quebec. The only provinces to record declines were Alberta and Nova Scotia.

> E-comm is driving demand for larger warehouse and distribution facilities that are well located and automated to support streamlined logistics

INDUSTRIAL ABSORPTION RISES AGAINST LOW OIL PRICES AND LOW CDN $



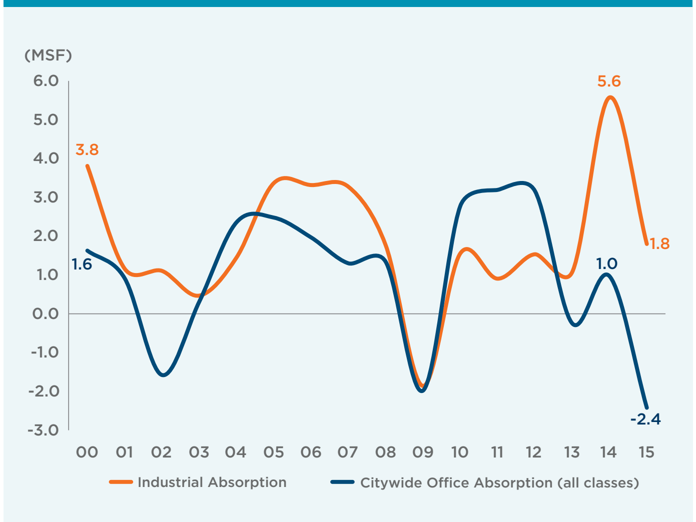
Sources: Cushman & Wakefield / Bank of Canada / Federal Reserve Bank of St. Louis

Source: Cushman & Wakefield

Industrial Renaissance: Toronto and Vancouver See Record Growth

- In 2014, **Canadian industrial absorption** reached 10.6 msf. 2015 saw a further acceleration of growth with absorption hitting 17.8 msf — the strongest performance across Canadian markets since 2005 and one of the hottest growth periods in history. All major markets contributed to this performance, including Calgary and Edmonton.
- **Toronto**, Canada's 800-pound gorilla — with 778 msf of inventory, making it the third largest market in the Americas — absorbed a remarkable 9.1 msf of space in 2015. This was the strongest growth Toronto has seen since Q1 2008, prior to the financial crisis.
- **Vancouver** saw the strongest expansionary growth relative to its size, with absorption rising to 2.2 msf a quarter over the latter half of 2015, the strongest pace the market has seen in more than 15 years.
- Even **Calgary's** industrial markets showed tremendous resilience as its downtown office market was being decimated because of the oil price shock. The market, which did not experience a single quarter of negative absorption in the past two years ending Q4 2015, saw 1.8 msf absorbed last year. Calgary's growth is being driven by e-commerce and strong growth within consumer goods distribution facilities, including both perishable and non-perishable products. While 2016 will see absorption shift into negative territory, distribution sector growth will help offset weakening oil-sector demand.
- **Montreal** finally saw the winds of change with absorption averaging 625,000 sf per quarter, and topping 900,000 sf in Q4 2015.
- **Edmonton** also saw positive absorption across 2015, though stress cracks have since appeared in key sectors, particularly in support of oil sands-related activities.

CALGARY INDUSTRIAL VS. CITYWIDE OFFICE ABSORPTION (ALL CLASSES)



Source: Cushman & Wakefield

- **Winnipeg** is now viewed as a safe haven for capital. Strong investment demand has put pressure on premium product cap rates. Slow and steady will continue to characterize the market.
- Federal government spending cutbacks will continue to restrain **Ottawa's** industrial growth.
- **Moncton** has seen climbing vacancy and weak absorption as tenants relocate into modern new facilities and displace older product.
- **Halifax** has seen variability in vacancy and overall absorption, while **St. John's** has been hit hard by the fall in oil prices, with its industrial vacancy reaching 14.2% in Q4 2015.

DRIVERS OF INDUSTRIAL REAL ESTATE

Exploring the Drivers of Demand

- As expressed in Scotiabank's *Global Economic Update*, March 2, 2016: "Canada's relatively modest growth reflects a highly imbalanced regional performance, highlighted by the significant retrenchment in investment and hiring underway in the energy-dominated producing provinces of Alberta, Saskatchewan, and Newfoundland & Labrador. At the same time, an important rebalancing is underway towards B.C. and the central provinces, which are collectively benefitting from much more diversified economies in manufacturing, services, retail/wholesale activity, residential construction, in addition to non-energy resources."
- Although office markets in Calgary and Edmonton have been hit hard by sustained low oil prices, their industrial markets have been buoyed, in part by growth from the distribution sector. Edmonton and Calgary, however, have begun to see a significant deceleration in industrial leasing activity, and Edmonton particularly, will likely see absorption shift into negative territory through 2016. How deep will depend on where oil prices settle. Alberta markets will also face the tightening purse strings of the provincial government, whose revenues have fallen significantly alongside the plunge in oil prices.
- Growth in Vancouver and Toronto has been stimulated by a rapidly evolving e-commerce sector and related warehouse and distribution demand, along with strengthening export and manufacturing sales. Montreal markets have already seen significant growth thanks to the revival of its manufacturing sector, which helped drive positive absorption to more than 920,000 sf in the fourth quarter of 2015.

Outlook Brightens for Key Markets

The outlook for the Canadian economy brightened with stronger-than-anticipated GDP growth at the start of 2016. Real GDP is expected to advance by 1.9% in 2016 and 2.0% in 2017 (TD Bank), which will help spur demand for industrial product. The main drivers that propelled industrial demand to new heights last year remain in play for 2016, including low interest rates, a competitive Canadian dollar, and a buoyant U.S. economy. As well, the distribution sector will remain hot, as companies establish or expand their online presence and just-in-time delivery.

Acquisition demand will intensify in Toronto and Montreal's industrial markets, as both owner occupiers and investors compete for a growing shortage of quality product. The lack of supply will challenge each group in their efforts to satisfy their real estate needs. Vancouver and Toronto have seen a significant drop in vacancy over the past two years, and this will exert upward pressure on rental rates for top-grade product in key markets. While Calgary and Edmonton have shown tremendous demand resilience, the stress cracks will widen in 2016, and negative absorption is anticipated. However, the negative absorption due to the oil price shock will be partially offset by continued expansionary momentum from warehouse and distribution facilities related to e-commerce.

It will be critical for prospective buyers in the market to engage early and understand available product within this very hot market.

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