Reprinted from

FINANCIAL POST

NATIONAL POST, MONDAY, NOVEMBER 24, 2008

REAL ESTATE

Consider renegotiating leases

Office rental rates seen sinking fast despite low vacancy

Garry Marr, Financial Post

It almost makes no sense. Office vacancy rates are at or near record lows in most Canadian markets but just about everybody seems to think lease rates are about to sink very fast.

The real estate industry's data have become quickly out of date in a economy that is going downhill, which is translating into business needing less office space. "The big question on all tenants' minds is whether the [economy] is going to get worse. It is a more pressing concern for tenants who have leases expiring in the next 36 months," said Stan Krawitz, president of Real Facilities Inc.

Mr. Krawitz said small businesses can make a critical error during a recession by focusing on staffing and not looking at occupancy costs, which for most companies ranks as the second largest expense after payroll.

He said the issue is how much rental rates are going to dip and whether it makes sense to renegotiate a lease today or perhaps wait for another six months for the market to crash.

Part of the equation in Toronto's downtown office market are the four major towers under construction that are expected to be finished by the first quarter of 2010. They will mean a huge uptick in supply.

"Barring what had happened in the last 90 days, there was going to be a real pent-up demand for space between now and the end of 2009. There was concern for tenants about what was going to happen because the Toronto downtown core was full with no space," Mr. Krawitz said.

That was then. Now Toronto has 2 million square feet coming on to the market in 2010 that is not leased, he said. "Add that to the [struggling] economy and tremendous amount of sublease space coming on the market, and you will have a downward driver of rental rates."

He has some dire predictions for the Toronto market. Rental rents for A Class office space in Toronto are now $25 per square foot a year plus $25 per square foot a year for operating expense that includes taxes.

By 2010, he said the $25 base rent in Toronto's core could fall to as little as $15 per foot a year.
"I think the rest of the country is in the same boat as Toronto with the exception of Calgary and Edmonton," Mr. Krawitz said.

But even Calgary has its issues with about eight million square feet of new buildings now under construction. The city once had a vacancy rate of 0.1% in its downtown core but that is up to about 4%.

Concerns about the economy may have landlords more than willing to talk about renewing a lease early, said Paul Morse, senior managing director of office leasing at Cushman and Wakefield LePage. Some landlords are worried about their exposure to the market so they are willing to go longer on a lease," he said.

The problem is the downturn in the economy may not be priced into the leasing market just yet. Nationally, vacancy rates at the end of third quarter were 5.9%, down from 6.4% a year ago, according to Cushman & Wakefield LePage.
The fact pricing has not come down yet is frustrating many tenants, especially those with U. S. parents who have watched rental rates decline rapidly in many markets south of the border, Mr. Morse said.

But landlords know bad times are coming. "Anybody we can renew, we are saying let's do it now," said a senior executive in the real estate division of a large pension fund. "We know bad times are coming. This is not a landlord's market."

gmarr@nationalpost.com