

PERSPECTIVE ON REAL ESTATE 2005 - UPDATE

EXECUTIVE SUMMARY

In mid-2004, *Perspective on Real Estate 2005* predicted that strong capital flows into real estate would continue as long as bond yields did not rise by more than 75 basis points and investor expectations regarding the future performance of equities and bonds remained lacklustre. Over the past three quarters, bond yields have actually declined, and consequently strong investor interest for real estate has continued.

Pricing has reached new highs and cap rates have dropped by an average of 25 to 75 basis points across all property types since mid-2004. Going forward, additional capital appreciation as a result of cap rate compression will likely be limited, although investor interest in the sector will provide pricing support for properties through the remainder of 2005. We do believe, however, that we are at or near a cyclical peak, and that if long-term interest rates rise significantly more than predicted (75 bps by the end of 2006) or there is a major decline in tenant demand, there will be downward pressure on prices in 2006 and 2007. Any correction is expected to be more moderate than in the early 1990's due to the stable property fundamentals and the strong institutional ownership base which exists today in the major Canadian urban markets.

Space market fundamentals also unfolded largely as forecast by *Perspective 2005*, in that there has been a recovery, albeit uneven, in select downtown office space markets. In addition, office absorption in the suburbs has modestly reduced the national suburban office vacancy rate. Signs of a recovery are also emerging in the multifamily sector. Industrial and retail property fundamentals have remained largely positive, and investor demand has been strongest for these two property types as a result. These generally healthy property fundamentals may also serve to underpin property values if the current capital inflows to real estate reverse over the mid-term, provided various factors do not tip the economy into recession. A cautionary flag flies over the Ontario and Quebec industrial sectors given the recent weakness in the manufacturing and export sectors. In general, the energy and commodity oriented Western Canadian economies should continue to outperform, resulting in strong property fundamentals in Alberta and B.C.

ECONOMIC OVERVIEW

GLOBAL

- In 2004, the global economy recorded its strongest performance in four years, registering growth of over 4.0%. However, growth had slowed by the end of 2004 as the expansionary phase of the current business cycle decelerated in the second half of the year. Conditions are expected to remain relatively healthy, and global GDP growth of 3.0% to 3.5% is anticipated for 2005.
- China's economy continues to expand at breakneck speed, with GDP growth of 9.5% being recorded in 2004. To date there is little sign of any moderation, with Q1 2005 growth recording a further 9.5% gain. Furthermore, the Chinese government has raised its long-term annual growth forecast to 8.0% from 7.0%.
- Energy prices will likely remain the economic wildcard in 2005. The price of oil briefly approached US\$60 per barrel in the first quarter before retreating to US\$50 per barrel. The U.S. economy has recently started to feel the impact of higher energy costs with economic activity hitting a soft patch in the opening months of the year.

UNITED STATES

- The U.S. economy expanded by 3.9% on an annualized basis during the second half of 2004, before slowing to an annual growth rate of 3.1% in the first quarter of 2005. Despite forecasts still predicting moderating economic growth, the Federal Reserve is expected to continue on its path of “measured” interest rate increases through at least mid-2005. Then, depending on the health of the economy, the Fed will either continue increasing rates or pause to assess future growth implications.
- Consumer spending has defied most forecasts and remained strong during 2004. However, spending levels are expected to slow as rising interest rates cause a decline in mortgage refinancing activity and consumers are forced to increase their savings rate from record lows.

U.S. REAL GDP GROWTH			
2002	2003	2004	2005f
1.9%	3.0%	4.4%	3.2%

Source: U.S. Bureau of Statistics and Bentall Capital

CANADA

- The Canadian economy has moderated since midyear 2004 due mainly to the appreciating Canadian dollar. In an effort to prevent further increases in the Canadian dollar, the Bank of Canada has kept interest rates flat. The question going forward is whether the BOC will remain on the sidelines or feel compelled to raise rates to defend the loonie in the wake of recent political uncertainty.
- While the manufacturing-sector dependent Eastern half of the country suffers due to the high Canadian dollar, the resource-rich West is experiencing strong economic growth as global demand for commodities remains robust. The previously buoyant housing sector has shown signs of slowing, and national construction starts in the sector were down 9% year-over-year during the first quarter of 2005.
- The Canadian unemployment rate reached a three-year low of 6.8% in April. However, the manufacturing sector continues to be negatively affected by the rise of the Canadian dollar, and 72,000 jobs have been lost in the sector over the past year.

CANADIAN MARKET INDICATORS				
	2002	2003	2004	2005f
Real GDP Growth	3.4%	2.0%	2.8%	2.6%
CPI Growth	2.2%	2.8%	1.8%	2.2%
Employment Growth	2.2%	2.2%	1.8%	1.4%
Unemployment Rate	7.6%	7.6%	7.2%	6.8%
Real Consumer Expenditure Growth	3.4%	3.1%	3.5%	3.3%
10-year Gov't. of Canada Bonds*	5.07%	4.80%	4.45%	4.60%

**Average for year-end quarter*

Source: Statistics Canada and Bentall Capital

REAL ESTATE INVESTMENT TRENDS

- The ICREIM / IPD Canadian Property Index recorded a 12.9% return in 2004, the highest annual rate of return in six years. While the income component of the return was a stable 8.5%, strong capital growth of 4.4% was driven by appraisals that incorporated recent increases in property prices.

- Cap rates have declined an additional 25 to 75 basis points since mid-2004. This cap rate compression is due primarily to the continued flow of capital into the real estate sector. In addition, a combination of continued low interest rates and intense competition among lenders has resulted in extremely low debt costs, and consequently investors have been able to achieve their return targets despite higher asset pricing.
- Intense investor competition for yield-generating assets has caused the premium for riskier cash flows to diminish for many investment types. In certain instances, the traditional pricing spread between top-quality and secondary properties has narrowed. In addition, many institutional property investors seeking higher returns have recently expanded their definition of locations that fit within their “core strategies” to include secondary markets. It is therefore important for investors to incorporate realistic underwriting assumptions into pricing models in order to properly reflect the risk of acquisitions in the current market.
- Some pension funds have recently shown the willingness and ability to be aggressive bidders for select top-quality properties by adjusting their pricing parameters and increasing their use of debt. This has allowed them to be increasingly competitive with the REITs and foreign buyers who had dominated certain segments of the acquisitions market during 2003 and much of 2004.
- There is a growing perception that the investment market is reaching the top of the cycle. Further capital appreciation for most properties will likely be limited, and investors should concentrate on income yield when evaluating a property. The depth of the capital flows into real estate will likely provide support for current pricing levels through to the end of 2005. However, the real estate investment market is vulnerable to external factors that may cause a moderate downward shift in pricing at some point over the next 24 months. We do not believe that most segments suffer from either a demand peak or excess new supply, but most cap rates have declined to near historic low levels and are vulnerable to rising interest rates or tenant demand contraction.

REAL ESTATE ASSET CLASS TRENDS

DOWNTOWN OFFICE

- *Perspective 2005* forecast that an increase in tenant demand would lead to a reduction in free rent periods and tenant inducements, and ultimately an increase in face rates. Space market conditions have unfolded largely as predicted, and the national Class A vacancy rate fell to 8.5% by Q1 2005 from 9.3% as of mid-2004. However, the actual timing and extent of the downtown office market recovery has varied significantly across markets.
- Downtown office space market conditions have largely mirrored economic conditions across Canada; tenant demand has been strong in the West but mediocre in the East. In Toronto, space demand has been moderate, although the Class A vacancy rate dipped to 10.3% as of the first quarter of 2005 from 10.8% three quarters earlier. Leasing activity has come almost exclusively from existing tenants expanding or trading spaces within the Downtown node. The Montreal market experienced similarly mediocre conditions, and although tenant demand is expected to improve slightly, the market will likely remain soft for the remainder of 2005. In contrast, Vancouver and Calgary have experienced rental rate growth of above 10% for premier space since mid-2004. Calgary’s downtown Class A vacancy rate reached a multi-year low of 5.4% as of Q1 2005, and in Vancouver, the amount of premier Class A space that remains vacant is negligible.
- Only 576,000 sf of new downtown office supply will be delivered nationwide in 2005, which will help ensure decreasing vacancy and rising NERs (net effective rents) in most markets. However, improved

conditions are leading to the announcement of development projects in some centres. Developers have already responded to improved fundamentals in Calgary by announcing the construction of three largely speculative projects totaling 1.5 million sf. In addition, the tightening space market in Vancouver means some construction will commence during 2005.

- Transaction activity involving downtown office properties remains extremely limited, and the combination of heated investor demand and the lack of investment offerings has driven cap rates down by 25 to 50 bps since mid-2004. One of the most significant transactions in the first quarter of 2005 was the sale of 121 & 160 Bloor Street East (590,769 sf) in Toronto to Credit Suisse for \$121 million (approximately 7.0% cap rate / \$205 psf). The sale of the O&Y office portfolio is expected to set a new pricing benchmark when it closes in the second half of 2005.

SUBURBAN OFFICE

- As with downtown office markets, the recovery in suburban office market fundamentals has been uneven across the country. National absorption of 3.5 million sf during the four quarters to the end of Q1 2005 combined with limited new supply has resulted in a vacancy rate decline to 12.8% from 15.2% as of midyear 2004, however, there have not yet been significant NER increases in any market. While the overall suburban market is on the road to recovery, numerous pockets of weakness remain.
- The modest improvement in suburban office conditions has been aided by the slowdown in new supply during recent years. New supply will drop from 2.3 million sf in 2004 to only 1.4 million sf in 2005, of which almost 60% (816,000 sf) will be in the GTA West market. These figures are well below the 5.3 million sf of new supply that was delivered to the national suburban office market annually between 1999 and 2002.
- In the GTA, there is a marked contrast in space market fundamentals between the various submarkets. The North York-Yonge submarket is struggling with a Class A vacancy rate that reached 16.5% as of the end of March. Landlords in the submarket continue to offer significant tenant incentives in an attempt to fill abundant available space. In contrast, the Meadowvale and Airport Corporate Centre nodes of the GTA West market have tight Class A vacancy rates of 4.0% and 9.3% respectively, and there is expected to be upward pressure on NERs in these nodes going forward.
- Ottawa's Kanata submarket experienced absorption of 331,000 sf in the three quarters ending March 2005, and the vacancy rate declined to 23.1% from 30.2% over this period. However, tenants still have numerous options and NERs are likely to remain in the low single digits until excess supply is absorbed. Similarly, in Vancouver's Burnaby market, Class A NERs have remained flat and landlords continue to offer significant inducements in an effort to attract tenants.
- Despite the absence of a uniform recovery in space market fundamentals, cap rates have declined by 25 to 50 basis points (the least of any property type) across the major markets since mid-2004. Transaction activity has been concentrated in the GTA market, where German investors made two significant purchases in the second half of 2004. In July, Northam purchased the Kolter office portfolio (2.4 million sf of Class A and B properties) for \$457 million (approximately 8.6% cap rate / \$191 psf). A month later, Deutsche Bank Real Estate Management purchased North York's Transamerica Life building (542,000 sf) for \$181 million (approximately 7.3% cap rate / \$334 psf).

INDUSTRIAL

- As predicted in *Perspective 2005*, the national vacancy rate was stable during 2004, and finished the year at 4.8%. Rental rates have remained steady or increased slightly across most markets.
- In Toronto, absorption was a modest 1.1 million sf during the second half of 2004. Both NERs and vacancy (5.0%) have remained steady since midyear 2004. However, new supply threatens to pull the market out of equilibrium in coming quarters. A number of U.S. developers, attracted by the relatively strong GTA space market, have announced plans to begin ambitious development programs. Owners of older, smaller properties will likely lose tenants as large users consolidate their space requirements in these larger, more efficient buildings. Vacancy is expected to increase and rental rates may soften toward the end of 2005 as supply begins to outpace demand.
- The Montreal market experienced almost 2 million sf of negative absorption in the second half of 2004, and rental rates have declined moderately over this period. The Calgary market has performed slightly better, although excess supply may compress rental rates for existing properties in the near-term. In contrast, Vancouver's industrial market continues to enjoy the best conditions of any North American city. Vacancy remains low at approximately 2.0%, and rental rates increased by an average of 5% during the first quarter of 2005 after remaining flat for much of 2004.
- The sellers' market continues, as industrial property prices have increased and cap rates have declined by 50 to 100 bps since the second quarter of 2004. Pricing is now approaching or exceeding replacement cost in several cities, resulting in an increased amount of speculative construction. There have been a number of portfolio transactions that have set unprecedented cap rate lows. Most significant were the sale of the Menkes GTA portfolio of 54 industrial and 8 office buildings for \$447 million and the sale of the GPM's 25-building GTA and Ottawa portfolio for \$117 million. In response to the aggressive pricing, some institutional investors have ventured outside of the major markets in search of available product and better returns. An example is the purchase by the Ontario Pension Board of the Roycom portfolio (700,000 sf) in Halifax for \$60.5 million (approximately 8.0% cap rate / \$86 psf).

MULTIFAMILY

- Multifamily space market fundamentals were expected to weaken during the second half of 2004. As predicted, the national vacancy rate as reported by CMHC rose for the third year in a row, increasing from 2.2% in 2003 to 2.7% by October 2004. During the first quarter of 2005, fundamentals in the multifamily market have shown tentative signs of improvement. The vacancy rate is expected to decline as rising mortgage rates and increasing prices begin to erode housing affordability and increase tenant demand for rental units.
- The key issue with multifamily investment over the past few years has been the relative increase in operating expenses, which are generally not recoverable from tenants. Even in markets where rents are recovering, expenses such as utilities and insurance have been growing at a faster rate, thereby squeezing net operating income. Lower refinancing costs have partially offset this issue, but if interest rates begin to rise, the forecast NOI will become threatened.
- Rental rates have stabilized, or even begun to increase moderately, in most markets following two years of decline. In addition, landlords' use of incentives (such as free rent periods) used to entice tenants in recent years has subsided in Vancouver and Toronto. Vancouver has seen the most significant improvement in conditions due to a healthy economy, strong migration and high home ownership costs.

The city's multifamily vacancy rate declined to 1.3% as of October 2004 from 2.0% a year earlier. Rental rates bottomed in mid-2004 and have since increased by approximately 2%.

- In Toronto, the vacancy rate rose to a new high of 4.3% as of October 2004 due to weak tenant demand and abundant condominium supply. Despite this increase in the vacancy rate, rental rates increased moderately (less than 1%) in 2004, indicating that the market is turning the corner towards a recovery. Conditions in Calgary were less robust. In the year to October 2004, rents declined by 1% and the vacancy rate stabilized in the mid-4% range.
- Limited supply of new quality offerings and continued investor interest in multifamily product has resulted in increased per-unit transaction prices despite relatively weak sector fundamentals. A number of large, privately-owned Class B and C portfolios have been put up for sale by owners hoping to capitalize on the current investment market. However, these offerings have received a lukewarm reception from institutional investors, whose desire for higher-quality assets and conservative underwriting assumptions have precluded aggressive bids for lesser-quality portfolios.

RETAIL

- Retail has had the strongest fundamentals of any property type over the past three years. *Perspective 2005* predicted that consumer spending would slow in the second half of 2004 after a continued stretch of robust growth. Due partially to continued low interest rates, retail sales (ex. autos) growth in 2004 (5.8%) actually exceeded 2003 levels (4.2%) by a significant margin. Regional disparities continued, as sales growth in Western Canada registered 8.4%, while sales growth in the East reached only 3.4% for the year. Housing-related sectors did exceptionally well, with the Building & Outdoor Home Supplies and Furniture & Home Furnishings categories outpacing all others with growth rates of 10.3% and 9.0% respectively.
- According to the ICREIM / IPD, Super-regional malls had the lowest vacancy rate of any property type included in the IPD Index during 2004. At 2.4%, the vacancy rate was well below that of Regional malls (5.3%), Community retail centres (3.5%) and Neighbourhood retail centres (12.2%). These stable fundamentals explain the popularity of Super-regional malls among large institutional investors seeking stable cash flows.
- Retail properties of all types remain heavily pursued by investors attracted by the stable income streams these properties generate. Cap rates have dropped an average of 50 basis points since mid-2004, with food anchored retail strips seeing the largest decrease (50 to 125 basis points) of any property type. Modern, well-located retail strip centres in Toronto and Vancouver now routinely trade at cap rates in the 7% to 8% range, and occasionally dip below 7% for premier properties. The lack of offerings combined with the cap rate decline for retail centres in major markets has driven many REIT and pension fund investors to secondary markets in search of more favorable yields.
- The popularity of retail property is reflected in the large proportion of transactions in 2004 that involved this property type. Retail property transactions in 2004 totaled \$3.4 billion, which represents 40% of all transactions greater than \$20 million. The largest single property transaction since mid-2004 was the sale of Marché Central, a 957,000 sf regional power centre in Montreal, for \$303 million (\$317 psf). There have also been a large number of portfolio sales in 2004, reflecting the desire of large investors to quickly and efficiently place capital in the retail sector. The most significant portfolio transaction is Calloway REIT's announcement that it plans to acquire 36 Wal-Mart anchored malls from FirstPro and Wal-Mart Canada. The proposed sale is valued at \$1.2 billion, and will make Calloway the second-largest public retail landlord in Canada.