

PROPERTY REPORT

Industrial is belle of the real estate ball

Countrywide boom is being driven by high demand from investors who value the properties' stable rate of return

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Industrial real estate, the often overlooked stepsister in the commercial property sector, has emerged as a true Cinderella.

Unprecedented demand across Canada has driven vacancy rates to record lows and trimmed capitalization rates, the rate of return on an all-cash basis, to bond-like levels, according to industry experts.

"We are in great shape right across the country," says Keith Reading, vice-president of research at Toronto-based real estate broker Colliers International. "Vacancy rates are low in every major centre, new buildings are leasing up quickly and new development is going on at a conservative pace."

The boom in industrial space is being driven by unprecedented demand, not just from tenants but from investors as well, says Stefan Ciotlos, executive vice-president at CB Richard Ellis Ltd.

"There is enormous investor interest," he says. "Pension funds, REITs, private investors and companies that want to own their own space are all competing for whatever is available.

"The lure is stability, low maintenance and solid returns."

In a way, industrial properties have become the business income trusts of the commercial property field. Competition for good properties is so great, however, that cap rates have plummeted, with properties selling at or above construction costs.

In November, for example, **Menkes Developments Ltd.** of Toronto sold 11 buildings totalling 1.5 million square feet to an unidentified pension fund for \$147-million, or \$97 a square foot, the equivalent of a 5.7-per-cent cap rate, according to industry sources.

Canadian Tire Corp. Ltd. sold two of its distribution centres, one in Toronto and one in Calgary, to H&R REIT and then leased them back on a 20-year basis. The cap rate on that deal was in the 6-per-cent range.

"In effect that deal traded at about 80 to 100 basis points above Canadian Tire bonds," says Paul Finkbeiner, president of **GWL Realty Advisors Inc.** "If you were just looking at returns, you would have been better buying Canadian Tire bonds." (A basis point is a hundredth of a percentage point.)

Even in Halifax, with an industrial property base of just nine million square feet, intense competition has driven cap rates down significantly, says Bob Mussett, vice-president at CB Richard Ellis.

"Last year, for example, Roycom [Inc.] sold 600,000 square feet to the Ontario Pension Board at an 8-per-cent cap rate," he says. "That is about 300 basis points down from what the property would have gone for just a couple of years ago."

Returns, however, are not the only consideration when it comes to industrial properties. Mr. Finkbeiner's own company has been busy adding industrial space to its office portfolio for the past four years and now

holds 16 million square feet across Canada.

"We have always liked industrial properties. We look on them and on residential as more bond-like products. Retail and commercial are more like equities," he says. Industrial properties "don't have the risk implicit in office properties, nor do they tie up capital. You can get an industrial building up and running in between six to nine months."

"We especially like multitenant properties. They spread the risk. Losing one tenant is not going to cause major problems."

The downside is that multiple-tenant properties have proved so popular they are becoming difficult to find, says Michael Cooper, president of Dundee REIT, which has nine million square feet of industrial space in its portfolio. In the past, Dundee has focused on buildings split into 3,000- to 5,000-square-foot premises.

"The problem we face is that multiple-tenant buildings are in very great demand and little new stock is going up because they are much more expensive to build," he says.

Too true, says Paul Braun, managing director of **CanFirst Capital Management**.

"There is little interest from developers in doing multiple-tenancy buildings," he says. "They can put up a single-use building for \$60 a square foot and sell or lease it with ease. If you have to divide the same structure into 5,000- or 10,000-square-foot units, the cost is going to be \$90 to \$100 a square foot, which is close to the selling price, so why bother?"

CanFirst has made its investors extraordinarily high returns on industrial investments. In 2002, for example, CanFirst organized a \$45-million, seven-year, closed-end fund to invest in industrial properties. To date it has generated a 33-per-cent-a-year return in cash and capital appreciation. Minimum investment in that fund was \$100,000.

CanFirst this year raised a \$55-million fund, also aimed at industrial real estate investment. This time units were priced at \$250,000. While investors cannot expect similarly stellar returns, the fund expects to produce rates in the mid-teens, Mr. Braun says.

"We look at B-type properties. We can't look at double-A buildings because we can't compete with the deep pockets and lower returns of the pension funds," he says. "Still, there is product out there. We have spent about a quarter of what we raised with the second fund so far and are pleased with what we have gotten."

While the Toronto area is enjoying vacancy rates hovering just above 5 per cent with little change expected for next year, the Vancouver market is close to having no space available at all. The vacancy rate at the end of the third quarter was about 2 per cent, says Chris Clibbon, senior research analyst at CB Richard Ellis.

"We have high demand but little space to build," he says. "There is the U.S. to the south, the mountains to the north and the ocean to the west. The only way we can expand is by pushing east into the valley and the land there is mostly agricultural and protected by provincial legislation."

While Abbotsford recently succeeded in getting 411 acres of low-grade farmland released for industrial use, it had originally applied for twice that amount, he says.

In southeast Surrey, the Campbell Heights Industrial Park brought 260 acres onto the market last year.

"When they brought the land to market it went for \$320,000 to \$420,000 an acre. Today it sells for

\$400,000 to \$600,000 an acre," Mr. Clibbon says.

Calgary is booming as well, says Marshall Toner, vice-president of industrial leasing and sales at CB Richard Ellis.

"At the end of the third quarter the vacancy rate was 3.4 per cent, compared with 5.4 per cent last year. By the end of the year we will have built 1.5 million square feet of new space," he says.

What is driving the boom? The emergence of the Calgary-Edmonton corridor as a distribution centre, he says. A recent survey showed that 65 per cent of all new industrial space was occupied by ventures in the distribution and logistics businesses, while 25 per cent went to the energy sector and just 15 per cent to manufacturers.

"Just 10 years ago, we had about 70 million square feet of industrial space in Calgary; now we have 100 million," Mr. Toner says. "Industrial is booming."

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