Civic incentives prompt developers to go bigger, faster

Seven high rise office towers are underway in downtown Vancouver, where the vacancy rate is also rising: are developers moving too fast, too soon?

By BRADY FLEGUEL

Being a consultant to many market participants requires me to delicately consider the facts surrounding one of the hottest topics in the commercial real estate industry in 2014: **City of Vancouver** commercial development incentives. The best way to approach this is to consider the question in two parts: 1. Is there actually an oversupply of office space in downtown Vancouver? and 2. Is the city policy providing excessive incentives to developers to build office space?

In 2007, the city adopted the Metropolitan Core Jobs and Economy Land Use Plan. Hot on the heels of a number of office buildings being converted into residential condominiums, this plan was designed to ensure that there would be enough development capacity to accommodate future job growth and economic activity in the metro core. Residential uses were discouraged in the area (and subsequently removed from permitted uses within the zoning bylaws) while allowable densities were increased by 2.0 FSR (floor space ratio) in the central business district (CBD). This policy essentially "saved" downtown sites from being developed with condominiums.

Six years after the Metro Core Jobs Study was approved, we find ourselves with seven office towers under construction in the CBD. These buildings stand to add roughly 2,250,000 square feet of office density to the downtown market, an increase of about 9.2 per cent to the total inventory. More than half of the space under construction is preleased. The first three buildings are expected to be complete by 2014 with the remaining space scheduled for 2017 completion. If we consider the historical absorption rate, there could be five to 10 years of Class AAA inventory available by 2017– assuming that none of the seven additional proposed office towers in the CBD enter the market during this time frame.

Vacancy rates

Most brokerages have been forecasting an increase in vacancy from current record lows of 2 to 3 per cent (Class AAA space) to as high as 5 to 10 per cent by 2016-17. My cautious conclusion: increased vacancy levels will lead to a more sustainable market and slight downward pressure on rental rates.

It is often mentioned in the industry that the city is "giving away office density for free" in order to spur job space in the core. Yet a close look at the approved office projects shows that the majority of sites were not heavily incentivized to build. Some sites used unbuilt density under the existing zoning bylaw or official development plan (MNP Tower, 725 Granville Street and 800 Griffiths Way) while 745 Thurlow and 980 Howe gave up the opportunity to build residential uses in order to gain additional office density. 520 West Georgia was rezoned in combination with the residential tower at Robson and Richards and the **Telus** office building at 775 Richards Street. The land lift associated with this project was subject to the city's Community Amenity Contribution Policy with significant funds used to acquire and build a park at Smithe and Richards Streets and for tenant upgrades to city-owned space at the CBC Building. The developer of 475 Howe Street proposes a $15.1 million heritage renovation of the former Stock Exchange Building, at a cost of $47.50 per-square-foot buildable, for the incremental density increase. Overall, it would appear that the seven buildings underway are playing by the same rules as everyone else.

> *The current construction boom is a result of a handful of factors of which land cost only forms a portion of the equation."*

Factors

There are really three factors that play into the economic feasibility of any real estate project: land cost, build cost (including profit) and end value. Any change to these three inputs can push a project from the back of a napkin to a shovel in the ground. I would say that build costs for high rise office space have been flat in the past decade. As discussed previously, the city is offering development flexibility to a number of sites, but the allowances are in lieu of significant costs to the developer; thus land value has not been significantly influenced. This leaves building valuations as the highest contributing factor to economic viability. From the period of 2008 to 2013, my analysis of office activity in the CBD shows appreciation of 10 to 15 per cent per year through a combination of yield compression, increased rents and lower vacancy.

The largest contributor to increased valuations is yield compression caused by favourable lending rates, highly capitalized market participants and a desire to own and manage AAA office assets without overpaying from an existing owner (i.e. build to own), among other reasons. A prime example of the market depth was shown when the Stock Exchange Building, proposing 360,000 square feet of office space, broke ground without announcing an anchor tenant.

There is no question whether the city's influence has made the development of office space more feasible through zoning flexibility and thus tempering land costs.

I would certainly hesitate to call this over-incentivizing the construction of office space. The current construction boom is a result of a handful of factors of which land cost only forms a portion of the equation.

The appreciation of prime assets appears to be the leading cause of what I cautiously consider a road to a balanced office market in downtown Vancouver. ■

Brady Fleguel is a principal with Burgess, Cawley, Sullivan & Associates Ltd., a real estate appraisal and property-tax appeal firm and an accredited member of the Appraisal Institute of Canada. His work encompasses projects throughout British Columbia.