Recession and real estate

The outlook for Canada. Existing leases for space will keep commercial landlords afloat for short term

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Real estate, specifically bad loans to the wrong people, is at the root of the financial crisis in the U.S. That burst the speculative bubble, but the same hasn't happened in Canada. Banks were more careful about whom they lent to. Still, the Canadian economy is teetering on the edge of a recession and real estate will suffer, experts agree.

We asked Stan Krawitz, president of Toronto real-estate consulting firm Real Facilities Inc. about the prospects for commercial real estate.

Q: How is commercial real estate faring in these recessionary times? Are real-estate developers able to find financing? If so, where and at what terms? If not, why not?

A: In the current environment it's only the very strongest developers with the strongest tenants in the strongest markets that are getting financed. Furthermore, any new real-estate development must be pre-leased with "AAA" covenant tenants, with long-term leases at market rates. Anything less than this has almost no chance of obtaining financing. There is no question the current real-estate development environment is very challenging for developers.

The commercial landlord business, on the other hand, is managing to hold its own as landlords continue to operate their businesses on the strength of their existing leases with their existing tenants. The major consideration for landlords operating commercial buildings will be the duration of these difficult economic times rather than the immediate severity of the times. Their challenges will begin when their existing financing terminates and new financing is required. If it's another 18 to 24 months before the economy improves, most landlords will be able to ride it out. If the recession continues for, say 30 to 36 months, it will place most landlords, even the largest ones, under extreme pressure.

Q: A recent forecast out of British Columbia suggested that prices will fall off a cliff next year, and will drop by smaller amounts in two subsequent years. Do you expect this to be the case in commercial real estate in Quebec?

A: I think Quebec will follow the financial tone of the rest of the country, which, in turn, follows economic trends in the U.S. Because the majority of new real-estate developments are located in Montreal, Toronto, Calgary and Vancouver, those cities will be the ones affected the most with projects that cannot obtain financing. In our opinion, the situation in Quebec will be no worse or better than it is in Toronto, Calgary or Vancouver.

Q: As the economy shrinks and the recession takes grip, how will that affect the commercial real-estate market?

A: The credit crunch and the faltering economy started in the financial services sector, specifically the residential mortgage markets, and reverberated throughout the economy from there. As a result, most of the surplus office space we see on the market today was formerly tenanted by banks, mortgage companies, investment banks and brokerages. The automotive and manufacturing sectors, in general, have also been hit hard with layoffs and plant closings. The question is whether there is enough demand for space to deal with this extra supply. There are certain businesses that will grow in recessionary times. But, when we examine the situation, I think it's fair to say that, on balance, more businesses are shrinking than growing, and that there are not enough expanding businesses to absorb this extra space. Because of this imbalance in the market, landlords are going to have to compete with the sublet market and quickly figure out a strategy to keep themselves profitable.

We believe the issue for the commercial real-estate market in Quebec and other major markets in Canada will rear its head in the second quarter of 2009. A number of companies with long-term leases will shrink and no longer require all their space. They will be competing with their landlords to release or sub-lease the space. A year from now, 15 to 20 per cent of tenants' leases will be up for renewal, and when head landlords and sublandlords compete to rent space, we will see material rent reductions. In a nutshell, what we are seeing is rental rates are already dropping but a number of landlords have not recognized the magnitude. No doubt, 2009 is going to be a very interesting year for the real-estate sector.

Q: How do corporate space users recession-proof their business?

A: Most corporate space users focus their efforts on their single largest expense - payroll - often ignoring their second-largest expense - occupancy costs. This is a crucial error in recessionary times. A rule of thumb in office leasing is each employee accounts for between 150 and 200 square feet of office space. So if a firm lays off 100, they have an extra 15,000 to 20,000 square feet of unproductive space. This is no small consideration.

For the space user, renegotiating with the existing landlord is far less commercially onerous than relocating the entire business. The question is, how do you renegotiate with your landlord if your lease is coming up for renewal in, say, two or three years?

There can be significant benefits in extending your lease in exchange for a space or rent reduction. However, there is an art to this negotiation process and a science behind the financial calculations. The problem is that many tenants simply do not understand either the art or the science. The challenge is to find the delicate balance between the extension term length, the rental rate and the amount of space required.

In summary, what we recommend is that space and payroll issues need to be looked at together - and strategically. Office space and human resources relate to one another like a hand and glove and should operate in this way.

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