FLEXIBLE AND ASTUTE EXPERTS KEPT DOWNTOWN OFFICE MARKET A SEA OF CALM

BRADY FLEGUEL | Tight group proved pundits wrong as Vancouver's downtown office sector moved from strength to strength

> **The Exchange building has applied to convert floors 2 through 11 from office use to hotel**

Let's face it – investors and developers are one step ahead of the rest of us. In the past years, we've seen countless news articles about oversupply of office space in downtown Vancouver. And now – where do we stand?

The new Class AAA buildings that are under construction, or newly occupied, are 97 per cent leased (93 per cent leased if 980 Howe is included in the set). Only a handful of infill spaces remain in most new buildings. The new buildings were expected to attract tenants from lower-class buildings resulting in an upgrade trend leaving the least desirable buildings vacant and desperate for tenants. The 13 sites in process or rezoned for office uses should have flooded the market, creating a dearth of available space and significant downward pressure on lease rates.

This has not been the case. What has happened? The downtown market is largely controlled by a small group of investors with the long game in mind. The current cycle appeared oversupplied, so many sites were rezoned in order to lock in any community amenity contributions (CACs) payable at today's metrics. At the same time, no new sites commenced construction after the Exchange building (475 Howe Street – more on this later). A wrench in the gears came in mid-2016 as prior to this date developers could defer cash CAC payments until issuance of building permit. Now the city requires cash payments (if applicable) upon rezoning enactment. On a side note, the revised CAC policy is expected to encourage more rezonings to provide alternative amenity contributions (daycare, social housing, etc.) instead of cash payments.

What else happened? The Exchange building has applied to convert floors 2 through 11 from office use to hotel, thereby reducing the supply of new office space and absorbing 30 per cent of available space on this site. So as for AAA space, the Vancouver market looks healthy.

What about the migration of tenants? Will tired B- and C-class office buildings be rampant with vacancy?

First, we need to ask whether the amount of available B- and C-Class office space is overstated. As many of these buildings will become development parcels in the mid-term, landlords are enticed to keep tenants' lease terms short. For these buildings, asset agility is more important than current cash flow and landlords will carry more vacant space and allow occupancy from more transient tenants with demolition clauses. In other words, while the quantity of available space is factual, this figure may misrepresent the health of the B- and C-Class sector.

This downtown sector is also being stabilized by another ironic factor: the strength of the residential market. Scarcity of developable land has forced developers to land bank office assets for mid-term holds. There are seven notable short-term sites in the downtown core currently improved with office buildings that, when redeveloped, will decrease the B- and C-Class inventory by 565,000 square feet.

Many of these properties have low occupancy, and four have been rezoned or are in the process. Two of these sites may offer a unique opportunity to convert office space to residential use.

But wait, is that possible? In 2007, amid a number of office buildings being converted to residential (strata) use, the City of Vancouver created the Metro Core Jobs and Economy Land Use Plan, which discourages conversion of significant office space (50,000 square feet or greater) to residential use. This policy was designed to protect job space in the core. In 2009, the city published an Office Conversion Policy in the Downtown District – specifically in the DD-G zoning area. The conversion policy does not prohibit residential conversion of office space, but initiates a report to council to consider whether the conversion is in the public interest.

The report to council will assess

the following criteria (with my answers following):

(a) The current supply of office space and the projected demand for the next 25 years in the downtown, including the heritage districts. (Plenty.)

(b) The amount of office space being converted and the general pace of office space conversion. (Zero.)

(c) Whether the building is on the Vancouver Heritage Register (or is a post-1940 building worthy of inclusion on the register), is at risk, and heritage designation will result. (Not applicable.)

(d) The quality of the development proposal in terms of livability and design with consideration to the level of and proximity to land uses and amenities that support residential use. (Hire a good architect.)

(e) Proximity of rapid transit stations to support sustainable commuting alternatives through high accessibility and maximize the benefits of existing transit investments. (Waterfront station.)

In other words, this policy may apply to many sites in the core.

The possible trend of repurposing (converting or replacing) office buildings to residential uses has other benefits apart from reducing available inventory. These buildings would require rezoning, meaning that the building would be required to achieve LEED (Leadership in Energy and Environmental Design) status, helping with the city's Greenest City goals. Converted buildings would need to be vacated; thus existing tenants will backfill space in other buildings not eligible for conversion. Further, the downtown market will receive an injection of much-needed residential density supply, be it rental or condominium ownership.

In a market where vacant office sites and empty office buildings continue to be purchased, amid seven rezoned parcels, four applications and 1,585,000 square feet of rezoned office density lying in wait – clearly some people are one step ahead of the rest of us.

Appraiser Brady Fleguel is a principal with Burgess, Cawley, Sullivan & Associates. His focus is on development land, office buildings and other commercial real estate projects throughout British Columbia.