

Deloitte.

Commercial real estate

A catalyst to transform business
and enhance profitability



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Investment and development of commercial real estate can provide a tremendous opportunity for space users to transform their business to become more competitive, a particular challenge for Canadian businesses. Deloitte has undertaken substantive research about Canadian productivity relative to other countries and has identified an increasing gap for Canada that has been well publicized.

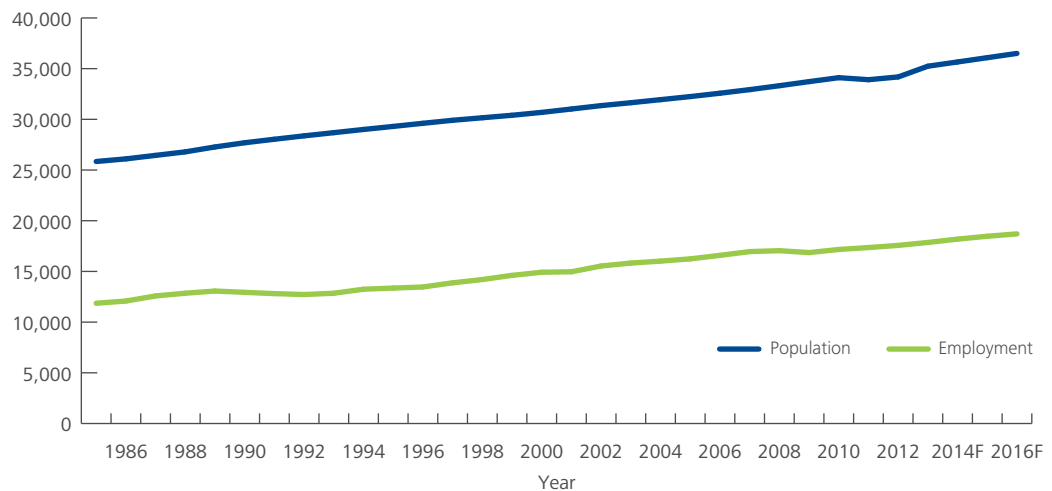
Commercial real estate has strong historic fundamentals

This article identifies the gap, and how space users across office, industrial and retail property sectors have the opportunity to realign their real estate to invest in their business and become more competitive for global markets. We believe that commercial real estate can act as a catalyst to enhance productivity in Canada.

Canada's real estate markets have shown strong historic fundamentals

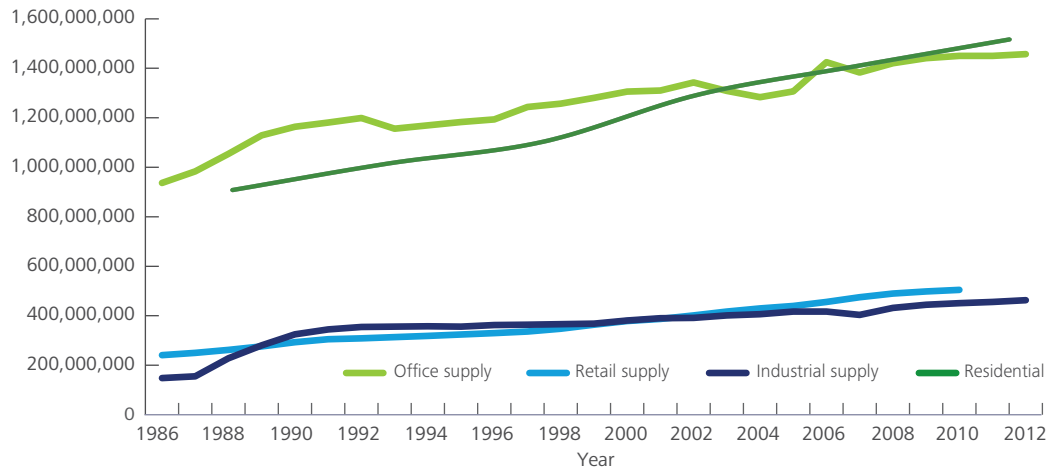
Commercial real estate in Canada has witnessed tremendous growth and strong performance over the past thirty years. Industry participants have enjoyed outstanding opportunities for investment, development of assets, services and property management. Virtually every asset class has grown including office, retail, industrial and residential as shown in the chart. In fact, there is a direct correlation between population and employment growth and real estate growth and performance. As businesses grow and expand the demand for space increases along with real estate commensurate with hiring new employees or adding new products or services. In the office and industrial sectors, for the most part the demand and absorption of space has remained positive over the last thirty years.

Canada's population and employment growth



Sources: OECD, Conference Board of Canada, Statistics Canada, 2012

Canada real estate supply growth



Sources: Cushman & Wakefield, CMHC, 2012

In addition to strength in the fundamentals of supply and demand, the investment sector has also performed well. Canada's REIT markets have outperformed both the TSX and the U.S. REIT market. The International Property

Index (IPD) that monitors the performance of Canadian institutional grade assets from the largest real estate asset managers shows that Canada consistently performs at the top of the global investment market.

Canadian real estate returns



Source: Scotiabank, S&P Dow Jones Indices, MSCI

Growing productivity gap is a major concern

The growing productivity gap is a major concern for Canada

Productivity, measured as output per hour of work, is a key contributor to Canada's competitiveness within the global marketplace.

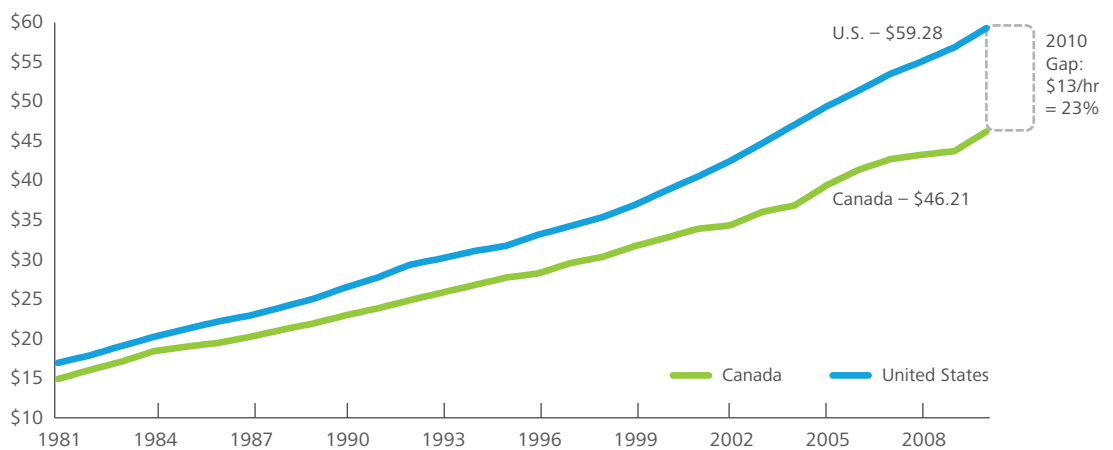
Unfortunately, Canada's productivity has not been growing as fast as in the United States. Since 1981 the gap has grown steadily. It currently sits at 23% and continues to widen: a trend that has prompted business leaders, major corporations and governments to focus increased attention on strategies to close the gap and improve

Canada's productivity. When this gap is evaluated in detail, we see that Canada's employment rate and hours worked are similar to the United States. The output per hour, however, is lower and many Canadian businesses continue to lag behind their U.S. counterparts. The space users of commercial real estate, both tenants and property owners alike, are also being challenged within global markets to deliver competitive products and services at efficient costs. Over time, this productivity gap will begin to seriously affect Canada's standard of living and this does not bode well for our future.

Canada's growing productivity gap relative to the U.S.

$$\begin{array}{|c|} \hline \text{Employment rate} \\ \hline \% \text{ of total population} \\ \text{that is employed} \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Work effort} \\ \hline \frac{\text{Hours}}{\text{Worker}} \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Productivity} \\ \hline \frac{\text{Output}}{\text{Hour}} \\ \hline \end{array} = \begin{array}{|c|} \hline \text{Standard of living} \\ \hline \frac{\text{GDP}}{\text{Population}} \\ \hline \end{array}$$

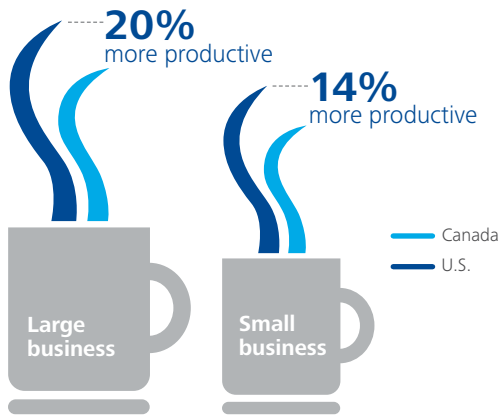
GDP per hour, Canada vs. U.S.



Sources: Centre for the Study of Living Standards, OECD

The productivity gap is largely independent of firm size. Both large and small Canadian companies are lagging their counterparts in the U.S. in terms of productivity.

Canadian companies losing steam to the U.S.



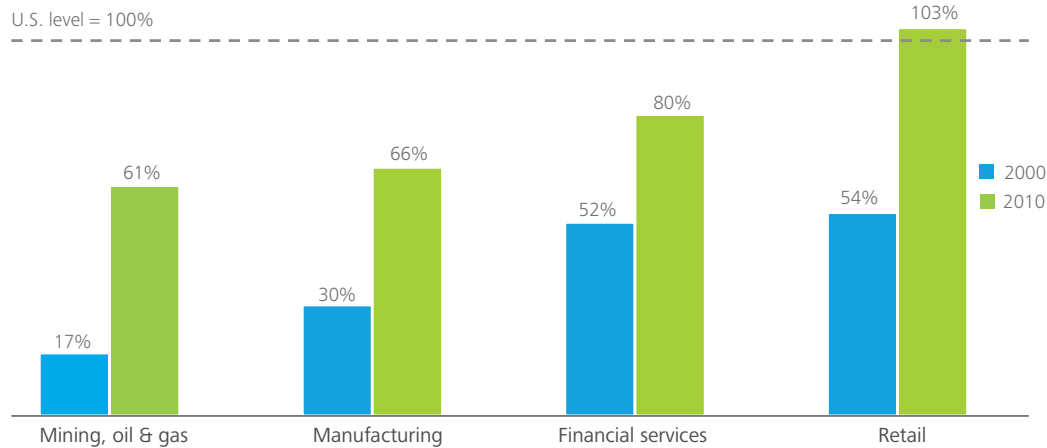
When it comes to productivity, U.S. businesses are outperforming their Canadian counterparts – in every firm size.

There are many reasons for this situation, which include:

- Aversion to risk amongst business leaders;
- Inefficient and insufficient support for innovation;
- Under-investment in machinery and equipment, along with information and communication technology;
- Shortage of risk capital for start-up companies; and
- Growing competition for talent both within Canada and across the globe.

Other factors that contribute to the widening productivity gap include a tendency for Canadian businesses to shy away from competition as reflected in Canada’s relatively low export intensity compared to other parts of the world. Canada’s investment in information and communication technology also lags in three sectors that are major contributors to our economic performance: mining, oil and gas; manufacturing (a proxy for industrial space); and the financial sector (a proxy for office space).

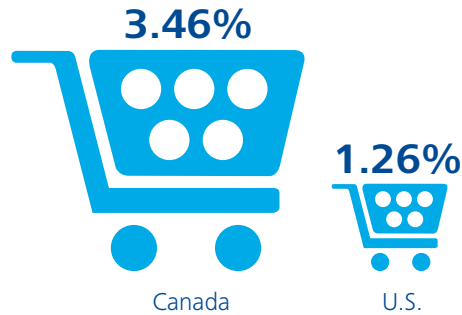
Canada’s ICT investment per worker as a % of the U.S.



Source: Centre for the Study of Living Standards

Canadian retailers outperform

Canadian retail sector outperformed the U.S.



Many U.S. retailers have expanded into Canada including Costco, Home Depot, WalMart, Apple and Target and others. In response, Canadian retailers have been forced to invest in their business platforms to remain competitive.

Canadian retailers outperform U.S. retailers in terms of productivity

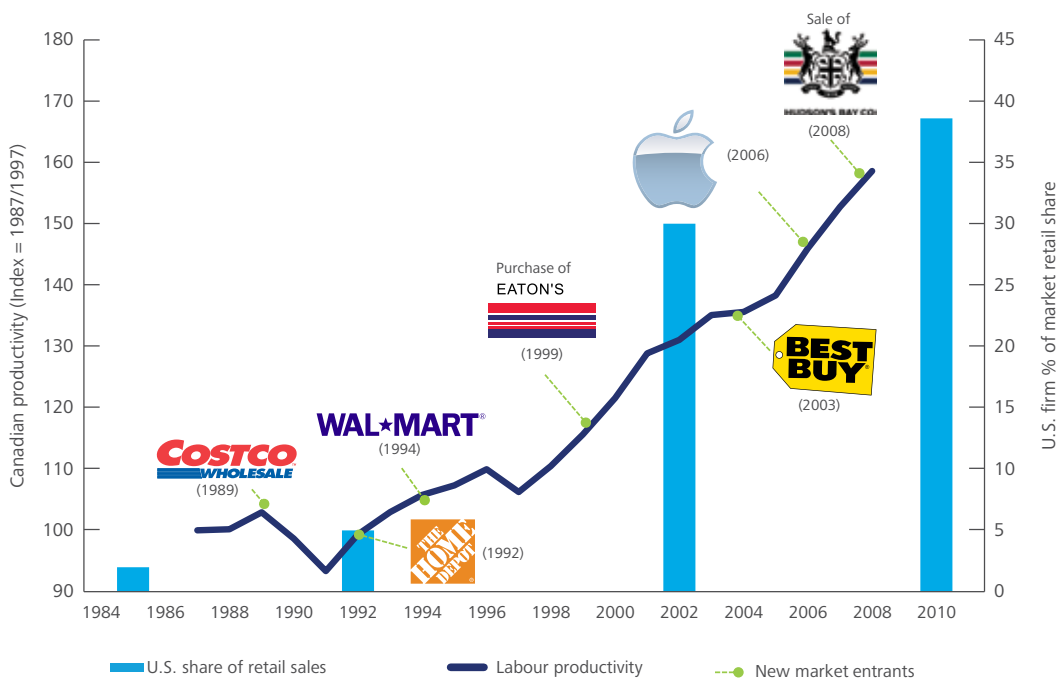
One of the notable exceptions to these trends is productivity in the retail sector, which has grown more rapidly than in the U.S. Deloitte's research indicates that this is largely in response to aggressive U.S. retailers who have entered Canada over the last decade, forcing the Canadian market participants to become more competitive and enhance their retail offerings. As a result of increased competition, combined with investments in information and technology, Canadian retailers have outperformed U.S. retailers and grown over 63% faster during the 2000-2008 timeframe as shown to the left.

Many U.S. retailers have expanded into Canada including Costco, Home Depot, WalMart, Apple and Target and others. In response, Canadian retailers have been forced to invest in their business platforms to remain competitive. The formidable legacy Hudson's Bay Company was also sold to U.S. investors and continues to gain market traction as a result of this new investment and competition. As a result, both retail spending and productivity in this sector have risen sharply.

Store metrics continue to evolve as technology enhances the retail experience and “path to purchase” for customers. Mobile price checking is becoming a competitive threat, reducing both the number of store trips and store transactions that are necessary. Every retailer is taking a different approach to realigning their portfolios in response to this trend. For example, Staples is shifting its business model towards more e-commerce. Target has plans to integrate its e-commerce and “brick and mortar” platforms to provide consumers with a multi-channel shopping experience. Other retailers are also evaluating their store models to ensure that their Canadian footprint is optimized.

Consumers are increasingly taking a non-linear path to purchase, combining both traditional store and internet channels. Ultimately these trends are anticipated to result in the rise of “omni-channel” opportunities for consumers to make purchases anywhere, anytime, for any product or any service. The increased control of consumers is not necessarily downsizing the stores, but it is leading to an evolution of store network models. Some retailers have chosen to develop a hub central store location in a major regional mall or centre with smaller “spoke” stores, while others have chosen to reduce the number of stores. Every retailer is creating a different business model for delivering products or services to the customer, in turn driving space decisions based on individual performance metrics.

Canada’s retail productivity and U.S. share of sales



Source: Centre for the Study of Living Standards

Manufacturing offers new opportunities

Evolution of retail driving growth in logistics and distribution centres

The strong retail growth over the past decade has increased the demands on the supply chain of products entering the Canadian marketplace. Partly as a result, the warehousing and distribution market has boomed with most of the major retailers acquiring or developing sophisticated new centres that can meet the “just-in-time” requirement of evolving retail platforms. For the most part, our industrial space is delivered to the market on a just-in-time basis, so, typically demand tends to equal construction of new space. For example, along with Target’s recent entrance into Canada, major distribution centres have been developed along with a new head office. This has helped to bolster market activity as developers and investors alike scramble to take advantage of the opportunity to secure these long term highly valued tenants and space users. In the rapidly growing Toronto market, vacancy rates are lower than throughout most of the US. Rates vary for other Canadian markets, with the national average slightly higher than participants prefer at just above 6%.

“Re-shoring” of manufacturing is an important economic opportunity

Over the last decade there has been much discussion about changes in the composition of employment and declines in the manufacturing sector. One of the major factors driving this trend has been the relocation of companies away from North America to developing economies to take advantage of lower cost structures, particularly with respect to labour. It has been most difficult for those cities and towns particularly in Central Canada that witnessed the exodus of jobs to either Asia, the southern U.S. or Mexico as a result of our decreasing cost-competitiveness.

In more recent years, however, this dynamic has begun to shift. Increasing labour costs, particularly in China, growing supply chain costs and risks as well as a variety of other factors are leading to a return or “re-shoring” of manufacturing to North America, notably for specialized types of manufacturing for which cheaper labour is not the only competitive advantage. Deloitte remains particularly interested in the manufacturing sector and most importantly, the economic opportunities associated with this re-shoring trend. A recent Deloitte U.S. study has identified the potential for 3.8 million net new jobs to be recaptured. By extrapolation using the 10% rule of thumb, based on market size and metrics, this research suggest that upwards of 350,000 jobs could be created in Canada, which represents an important economic opportunity.

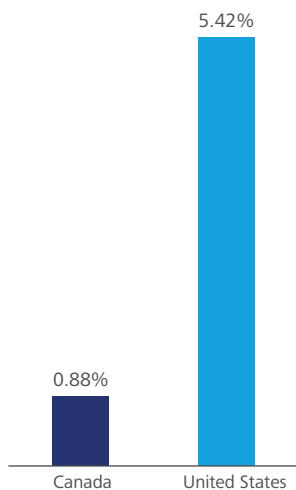


To capitalize on this opportunity, Canadian governments and businesses alike must aggressively pursue prospective companies and provide a favourable business environment within Canada. The increasing value of the Canadian dollar has dampened the global competitiveness of Canadian manufacturers within traditional environments. As shown below, between 1997 and 2010 the U.S. dollar cost of Canadian wages rose rapidly, diverging from the trend in the US, and eliminating a traditional cost advantage. Productivity growth has also not kept pace with the US, growing by only .88% or one sixth of the U.S. growth rate. Within this context, there is a clear need for Canadian manufacturing to adapt to currency and other competitive pressures over the medium and long-term.

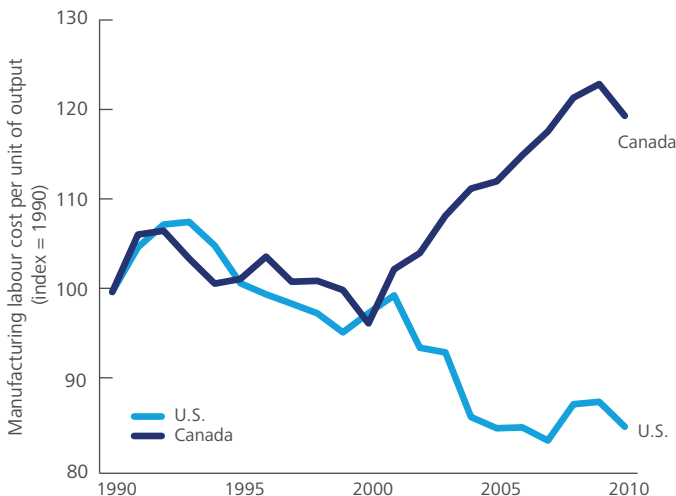
It is no longer sufficient to simply respond to economic development inquiries. A more proactive approach needs to be taken. Governments and businesses alike need to develop specific investment strategies to support high-value market segment and cluster related businesses. A full suite of initiatives must be applied to drive towards capturing future economic opportunities, including: target marketing, site selection analytics, business development, real estate campaigns and site availability promotion, financial and other incentives to foster innovation and lower the cost of doing business, and many other mechanisms. In our view, if such actions are not taken now, some of our brightest economic prospects could be lost. Prospective companies will simply choose to invest elsewhere to take advantage of the many opportunities provided by other countries and other markets in the aggressive global marketplace.

Canadian manufacturers have not kept pace with the U.S.

Manufacturing productivity CAGR 2000-2008



Manufacturing labour cost per unit of output, 1990-2010



Source: Centre for the Study of Living Standards, OECD

Office space users evaluate cost benefit for more productive employees

Office space users need to evaluate cost benefit for productivity returns

Canada's office markets continue to experience very strong performance, especially in the central business districts of major markets where vacancy rates are in the 4-5% range. One of the main reasons why demand and supply are well-balanced from an investment perspective is that pension funds and institutional investors have acquired most of the major buildings in Canadian downtown cities and have remained very conservative in their approach to the development of new space. Canada's office markets, both downtown and suburban, continue to have lower vacancy rates than their U.S. counterparts due to this conservative approach taken by the major real estate investors.

In Toronto, the vacancy rate for commercial office space is currently at 6.8%, largely because of the balance between the landlord and tenant market. In downtown, the rate is lower, 4.4%, a situation very much in the landlord's favour. As a result of the low rates, 3.8 million square feet is being developed to meet the demand from tenants between 2014 and 2016, creating a boom in the downtown office marketplace. A similar pattern is evident across Canada's other major markets where downtown vacancy rates average 5.4% and developers are launching new office buildings to capture demand.

Although the Canadian office sector is performing well from an occupancy and new building perspective, major office tenants are underperforming with respect to productivity. Canada's financial services sector, led by the banks, reveals a productivity gap compared with our global counterparts: a crucial difference given that financial services tend to be a dominant user of office space across Canadian markets. Productivity in the sector grew by only 1.86% between 2000 and 2009 compared to a rate of 3.53% in the U.S. Performance was also poor relative to Australia at 3.94% and the UK at 4.2%. Part of the explanation may be in spending on information, communications and technology, which is also relatively

low. The total ICT spend of the Canadian financial services is 80% of the U.S. level, yet only 42% of the U.S. when measured on a "per worker" basis. The sector is, in effect, under-spending on technology which could be impeding productivity growth.

Office relocations allow business to transform the workplace and drive productivity

Most of today's current office space tends to be traditional in design with large window offices, numerous cubicles and work stations and meeting rooms. Yet with advances in technology, the nature of work is shifting. Employees are working in many different ways – from client offices, home, and other locations. Even when in the office, workers are often away from their desks, in meetings and collaborating with others. Similar to the evolution of retail store networks, the design of the office environment is changing to accommodate this new way of working. Through a combination of communications technology and workplace strategies, more efficient designs are being achieved which, in turn, are allowing tenants to compress their space requirements. For office users, the relocation to new office space provides a tremendous opportunity to transform all aspects of the business, while at the same time driving down real estate costs and enhancing investment in technology to create a better work environment to drive more productive employees.

Office tenants evaluate the cost of office space – taking into account space efficiency, building performance, build-out cost, net-gross rent, cost per person, space cost per person and space cost per revenue – against major business elements, such as recruitment and retention, brand, office space design, sustainability and public transit access. It is all about productivity. How do you weigh office costs against the investment for more productive employees?



Office space users occupancy decision

Costs	Major requirements	
<ul style="list-style-type: none"> • Space efficiency • Building performance • Build out costs • Net and gross rent • Cost per person • Space (square foot) per person • \$ space costs as percentage of revenue 	<ul style="list-style-type: none"> • Recruitment & retention • Brand • Site selection • Building performance • Technology • Nearby amenities • Office space design 	<ul style="list-style-type: none"> • Space utilization • Sustainability • Public transit • "buzz", etc.

Utilization studies show that office seats often 40-60% vacant!

Employers are now routinely conducting utilization studies to determine how often an employee actually uses his/her space. The findings are not surprising, yet shocking at the same time. In many downtown offices, employees tend to sit at their desks only 30-40% of the time, depending on the business or organization. As a result, rather than the 5% vacancy rate identified by landlords previously, tenants

are recognizing that their space is some 40-60% vacant! Deloitte is using its new offices to advance productivity through innovative workplace designs and investment in communications technology. Our new builds in Toronto, Montreal, and Saint John are part of a new era of office space design and an important catalyst for bridging the productivity gap in Canada. In fact, Deloitte is undertaking a strategy to transform our spaces both in these new buildings and within existing offices in order to drive productivity.

Although the Canadian office sector is performing well from an occupancy and new building perspective, office space users are underperforming with respect to productivity.

Deloitte using new offices to advance productivity

Fortis Place
St. John, Newfoundland



Deloitte Tower
Windsor Station
Montreal
Cadillac Fairview



Bay Adelaide Centre II
Toronto
Brookfield Properties



Buildings need to be “future-proofed” to retain value for tenants and owners

In terms of the real estate industry, in order to remain competitive, both new and existing buildings will need to be “future-proofed” for flexible processes that allow businesses to be more competitive, both nationally and internationally. It means that we need to become much more creative and innovative, using our real estate opportunities to invest and reinvest back into our businesses and close the productivity gap.

For real estate industry participants, remaining competitive will require an even deeper appreciation of the fact that not all buildings are created equal, with pricing differentials widening as businesses significantly alter the way they use their space. This trend has implications for the entire market. Office, retail and institutional-grade assets continue to be of high priority for institutional investors because they provide a secure cash flow opportunity for pensioners, be they owners of REITs or pension funds. Hence institutional investors will often develop a business case to justify the asset upgrade or redevelopment.

Market participants also need to understand the specific real estate asset and, more importantly, the tenant’s demand and perspective for the asset. It’s not sufficient to assume a lease renewal as many tenants may reduce their footprint, or relocate to drive toward the cost savings and productivity enhancement through workplace transformation in their business operating models.

In our view, it is crucial that any investments in real estate – from a building owner or tenant’s perspective – take into account the rapid change that is occurring in technology, demographics, geography, finances and other crucial factors. For real estate decisions, the ‘status quo’ is no longer acceptable. In the new competitive environment it will be crucial for businesses and governments to have a thorough understanding of current conditions and future opportunities in order to drive productivity and performance.

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