

The Appeal of Office and Professional Condos

A Barclay Street Real Estate Brief

Executive Summary

Historically speaking, office condo units have traditionally been developed in small quantities in suburban markets and geared towards professional and medical service industries. The office condo concept has created an opportunity for occupiers to own their office space with the advantages of having fixed and clear costs, full control over the design within the premises and, significantly, tax benefits not available leasing tenants.

Looking forward, strong capital appreciation of commercial real estate, coupled with a low Canadian interest rate, presents an opportunity for developers to build additional office condos and subsequently attract an increasingly diverse group of occupiers and investors, while owners benefit from overall cost-savings and growing equity.

Ownership versus Leasing

Notwithstanding the economic difficulties of 2015 and year-to-date 2016, sizeable increases in lease rates have been noted across all types of office space over the previous decade in Calgary. Driving the escalation are factors such as a municipal focus on 'complete communities' in which office, recreation and residential developments are placed in close proximity to one another as a means of reducing the strain on infrastructure. Additionally, suburban markets have demonstrated a strong demand for space in higher-quality, often LEED certified, buildings. With lease rates continuing to rise and with Canadian interest rates remaining near-zero, local firms have been taking advantage of opportunities to own their office space at costs competitive with leasing.

The demand for office condos is typically driven by professional service firms - small to mid-sized business such as an engineering, law, consulting, accounting or contracting firms looking to build equity, as well as local and international investors seeking predictable cash flow. While demand varies across markets and building types, the increased office leasing price per square foot and the desire to own have created sought-after investment asset class within the office condo market.

A number of considerations must be taken into account when weighing ownership against leasing.

Topics	Own	Lease
GROWING EQUITY	As you pay down your principle and your property appreciates, your equity builds	Renting brings no economic benefit
RENTAL HIKES	Stable mortgage rates reduce uncertainty	The market and landlords decide for you
MANAGEMENT FEES	As part of a team of cost-conscious owners, you have your say on the condo board	Your lease and management company determine operating costs and will change management fees
TAX BREAKS	Depreciate your unit from its full value annually and write off operating and mortgage interest expenses	Write off your lease as a business expense
IMPROVING SPACE	Money spent for mezzanine and office showroom build out increases unit value	Improvements benefit landlord and may raise renewal rate
LONG-TERM BENEFIT	Unit is an investment that can be rented to a third party or sold with business	No economic benefit to you

Source: Hungerford Properties

During the past four years, Calgary's office real estate market has seen a significant increase in the development and sales activity of office condos. This has led to a fertile market in which developers are diversifying their portfolios among different real estate assets such as office buildings, hotels, mixed-use retail and residential real estate by adding office condo buildings and professional centres to their holdings.

Local examples include:

Project	Developer
634 6th	Genco Development Corp.
Douglasdale Medical and Professional Centre	Indevelopments Corp.
Fairmore Business Park	Hungerford Properties
Nexus Business Park	Hungerford Properties
The Windsor	Arlington Street Investments
Walden Square	Genco Development Corp.

Case Study – The Windsor

The Windsor by *Arlington Street Investments* is a five-story, mixed-use commercial development in close proximity to Calgary’s Downtown core.

Situated in *Windsor* - one of Canada’s highest household incomes and minutes from *Calgary Golf and Country Club*, this development is located in a walkable area in close proximity to restaurants, shops and green space.

The Windsor features nearly 25,000 square feet (sf) of retail and more than 70,000 sf of office space.



MARKET ASSUMPTIONS:

Sample office size: 1,500 sf

 \$28/sf basic rent

 \$17/sf operating costs

 \$45/sf tenant improvement allowance included

 1 parking stall

 \$275 / month, escalating \$25 every 5 years

 Basic rent, operating costs and parking over 5 years = \$354,000*

OWNERSHIP ASSUMPTIONS:

Sample office size: 1,500 sf

 \$585/sf base building

 \$45/sf tenant improvement allowance included

 \$14/sf condo fees

 1 parking stall included

 \$877,000 purchase price

 5 Year financing @ 3.5%; 25 year amortization

LTV	Mortgage	Down payment
85%	\$745,875	\$131,625

 Mortgage payments and operating costs over 5 years = \$329,000*

 Mortgage balance after 5 years = \$643,842

The scenario presented in the tables above addresses the opportunity and affordability of purchasing an office condo at *The Windsor*. Suburban Class A office lease rates in Calgary sit at approximately \$28 per square foot (psf) plus operating and parking costs, compared to an office condo selling for \$585 psf with modest tenant fit-up.

*This example demonstrates that even without factoring in any appreciation whatsoever in the value of the owned office space, a buyer would have built a minimum of \$233,158 in equity – as opposed to \$0 value in a lease situation – even though the annual costs are comparable.

Looking Forward

The office condo market in Calgary is on solid footing with strong demand among only a handful of office condo developments. At this time, the available product offers a wide variety of office and professional spaces, which can attract a diverse set of users and private investors.

The bulk of activity in this asset class has been focused primarily in the Suburban South markets; specifically, the SouthEast (SE) quadrant hosts approximately 65% of Calgary’s office condo and professional centre inventory, both current and

under construction. Expected to have a significant impact is the proposed SE *Green Line* branch of Calgary Transit’s Light Rail Transit (LRT) which will connect to more than a dozen SE communities, many of which currently contain office condo developments and professional centres. It is anticipated that the increased and expedited transit access to and from these areas will spur further commercial condominium development, particularly in the expanding community of *Seton* where Calgary’s newest hospital is located and multiple phases of retail and residential are planned.