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Analysis of Economic Rent Needed to Support New Industrial Construction

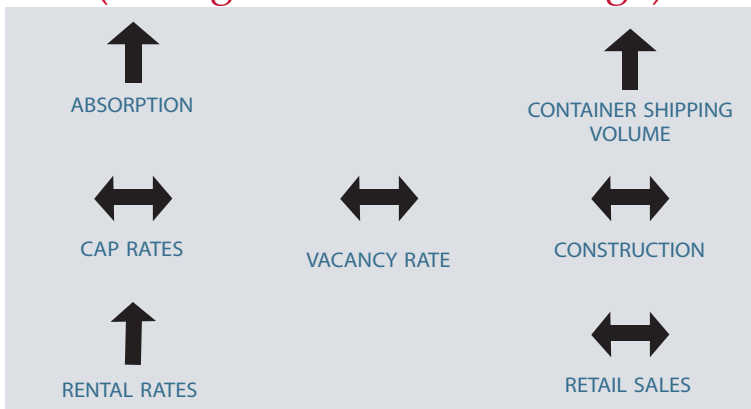
In the face of increasing land values and construction costs in the Metro Vancouver and Fraser Valley areas of BC, Altus Group and Avison Young have undertaken an analysis to explore the economics of new speculative industrial construction. The level of increase in costs has not been matched by a corresponding increase in rental rates, raising the question – ‘What is the relationship between economic rent needed to support the cost of new construction and current market rental rates for existing product?’

For this purpose, we have carried out a series of analyses based on a standard economic rent model relating general benchmark parameters for single tenant industrial uses in select industrial locations: South Burnaby – Big Bend, South Richmond, and Surrey - Campbell Heights. The economic rent model utilized is similar to a typical land residual analysis, however, the calculations are effectively inversed, applying current construction costs, current market land values, typical desired developers’ profit, and market capitalization rates as inputs to solve for the Required (Economic) Rent. The results

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Market Indicators

(Change from six months ago)



Metro Vancouver Industrial Overview

Summer 2008



Intelligent
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Metro Vancouver Industrial Market Snap Shot

MARKET	INDUSTRIAL INVENTORY (S.F.)	VACANCY
Richmond	31,744,347	1.93%
Burnaby	25,180,034	1.90%
Surrey	25,885,574	2.30%
Vancouver	21,693,391	1.03%
Delta	20,118,724	2.50%
Langley	14,523,350	4.70%
Coquitlam	7,432,394	2.00%
Port Coquitlam	6,030,309	0.70%
Abbotsford	5,132,498	1.90%
North Vancouver	4,902,624	1.00%
New Westminster	3,682,315	0.12%
Chilliwack	2,783,118	3.31%
Maple Ridge / Pitt Meadows	2,182,947	3.67%
Port Moody	900,872	0.00%
TOTALS	172,192,498	1.87%





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presented are based on the construction of a 'benchmark' single tenant, light industrial building of 50,000 sq.ft. (including a small office area) in the selected locations. For the purposes of our analysis, we have assumed a land value based on a fully serviced, preloaded, subdivided parcel of approximately 2.5 acres, with development cost charges pre-paid. It is noted that our analysis does not take into account conditions facing developers with existing land holdings (ie. 'cheap land') who may be able to construct new product more economically. Furthermore, we have not considered any advantages to the occupant associated with new construction, either from potential operating cost reductions (modern energy systems), or operating efficiencies through layout and design.

Commentary

The individual results for the Surrey, Richmond and Burnaby locations (see below) yield a Required Economic Rents per sq.ft. range of approximately \$11.25 to \$15.00, depending on land value and capitalization rate dynamics. The largest discrepancy in Required Rents versus Reported Market Rents occurs for the South Richmond location. At the mid-point of the range in cap rates and land values, the difference between Required Rent and Market Rent peaks at approximately 75% above reported 'Low' market rents.

Importantly, this model is sensitive to variations in the numerous inputs. A 10% increase in the construction cost estimate, from \$90 to \$100 per sq.ft. for hard costs, would result in approximately \$1.00 increase in economic rents. Alternatively, an increase of 150 bps to the overall average construction financing rate assumed would suggest an increase of \$0.25 per sq.ft. in economic rents. Furthermore, it is noted this analysis is only a snapshot of the current dynamics impacting the economics of single tenant industrial development. It is possible that Reported Market Rents will increase over the course of new construction periods, closing the gap somewhat between Required Economic Rents and Current Reported Market Rents.

Overall, as expected, the Required Economic Rent for each of the selected locations appears to be higher than the respective Reported Market Rent estimates, suggesting that increasing construction costs and rising land values continue

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Required Economic Rent Analysis Results *

South Richmond Industrial

Benchmark Industrial Cap Rates
for Single Tenant Asset

6.00% 6.25% 6.50%

"Hypothetical Benchmark

Land Value (Per Ac)"

\$1,300,000

\$1,400,000

\$1,500,000

Required Rent **

\$13.25	\$13.75	\$14.25
\$13.50	\$14.00	\$14.75
\$13.75	\$14.50	\$15.00

Reported Market Rents per SF - \$8 (Low) to \$11 (High)

Surrey - Campbell Heights Industrial

Benchmark Industrial Cap Rates
for Single Tenant Asset

5.75% 6.00% 6.25%

"Hypothetical Benchmark

Land Value (Per Ac)"

\$900,000

\$950,000

\$1,000,000

Required Rent **

\$11.25	\$11.75	\$12.25
\$11.50	\$12.00	\$12.50
\$11.75	\$12.25	\$12.75

Reported Market Rents per SF \$7 (Low) to \$9 (High)

South Burnaby -Big Bend Industrial

Benchmark Industrial Cap Rates
for Single Tenant Asset

5.75% 6.00% 6.25%

"Hypothetical Benchmark

Land Value (Per Ac)"

\$1,100,000

\$1,300,000

\$1,500,000

Required Rent **

\$12.00	\$12.50	\$13.00
\$12.75	\$13.25	\$13.75
\$13.25	\$13.75	\$14.50

Reported Market Rents per SF \$9 (Low) to \$11 (High)

* Results are based on typical benchmark industrial sites which are considered suitable for the construction of a single tenant, light industrial warehouse of 50,000 sq.ft. for specific locations within the Vancouver CMA and Fraser Valley. For the purpose of our analysis we have made the following assumptions with respect to 'Benchmark Site' characteristics:

- fully serviced, subdivided parcel with development cost charges paid
- on-site works, pre-load and fill completed prior to acquisition
- no contamination / environmental issues
- regular lot shape with suitable access and truck turning area

Construction costs estimates are based on standard light manufacturing, single tenant industrial buildings comprising of a typical office build out of 5.00% to 10.00% and ceiling clear heights of approximately 24 feet.

** Our Economic Rent Calculation is based on the following model:

- Land Acquisition Costs (Land Value @ market for ~2.5 acre site + Property Purchase Tax)
- + Hard Construction Costs (~\$90 per sq.ft. +10% contingency)
- + Soft Costs (25% of Hard Costs plus Financing @ 6%)
- + Desired Developer Profit (10-15% of Effective Gross Revenue)
- + Tenant Improvement Costs + Leasing Commissions (@ \$3 per sq.ft. of rentable area)
- + Selling Broker Fees (payable upon completion and at 3% assumed sale price of building)
- = Total Development Costs
- x Market Capitalization Rate (Based on hypothetical benchmark)
- = Required Net Operating Income
- ÷ Total Net Rentable Area (50,000 sq.ft.)
- = Net Required (Economic) Rent Per Sq.Ft.

Where 'Required Economic Rent' is greater than 'Market Rent' new construction is considered to be less viable

...Recent Industrial Lease Deals (> 40,000 s.f.)

ADDRESS	MUNICIPALITY	TENANT	SQUARE FEET
BDL	1751 Kingsway Ave.	Port Coquitlam	451,000
LG Electronics Canada	1020 Derwent Way	Delta	251,076
Axis Integrated Container Hub	16000 Portside Rd.	Richmond	172,500
Horizon Distributors	5589 Trapp Ave.	Burnaby	148,000
KM Logistics	1127 Derwent Way	Delta	137,000
Avcorp Industries	8295 River Rd.	Richmond	129,247
Jeldwen Windows	4916 275th St.	Langley	125,000
Viceroy Homes	12211 Horseshoe Way	Richmond	106,300
The Fashion Distributors	540 - 590 Chester Rd.	Delta	106,134
Owen & Company Ltd	8651 East Lake Dr.	Burnaby	100,675
Wild West Organic Harvest	12757 Vulcan Way	Richmond	93,475
Village Farms	5355 152nd St.	Surrey	91,782
Day 4 Energy	8168 Glenwood Dr.	Burnaby	90,000
Aritzia LP	8335 Winston St.	Burnaby	83,000
AMPCO	101 - 9 Burbidge St.	Coquitlam	70,000
Jace Holdings - Thrifty Foods	5355 152nd St.	Surrey	69,338
Kenroc Building Materials	2445 Canoe Ave.	Coquitlam	51,273
Dynamic Structures	78 Fawcett Rd.	Coquitlam	40,000

Recent Avison Young Transactions



Brewers Distributor Ltd.
Central Port Coquitlam, BC
1751 Kingsway

- 451,000 sq.ft. - 20 year term
- Built-to-Suit
- Developed by Private Investor
- Represented Tenant



3700 Lougheed Highway
@ Boundary Road
Burnaby, BC

- 7.4 Acres of Land



Jump Logistics
Delta, BC

- 22,100 sq.ft.
- Represented Tenant



Aritzia Distribution
Premises
Burnaby, BC

- 84,000 sq.ft.
- Represented Tenant

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to outstrip growth in industrial rental rates within existing buildings for these locations.

Recently, significant gains in industrial investment property values have tended to draw many industrial users towards ownership (as they seek to benefit from potential capital appreciation) versus tenancy options, tempering the current demand for existing rental stock. However, the growing imbalance between Required Economic Rent and Reported Market Rents points to a decrease in benefits for users from new construction. This, in turn, is expected to put greater demand on existing rental stock, a factor which could contribute to a rise in market rents going forward. However it is noted that the fragmented ownership of existing rental product tends to mitigate or slow rental increases.

For landlords and tenants, advice on lease terms, both new and renewal, is more valuable now than has been the case in the past.

1. Development Residual Method sourced from 'Real Estate Investment Analysis & Advanced Income Appraisal.' 2003, UBC Real Estate Division.

2. For the purposes of our analysis, we have made a series of assumptions with respect to the characteristics of the benchmark site, and general market parameters. Reference should be made to the set of assumptions as summarized in the Results Matrices.

Altus Analysis prepared by:

Samantha Sawyer – Valuation Consultant
Phone: 778-329-9278
Email: samantha.sawyer@altusgroup.com

and

Kasia Hajduk – Analyst
Phone: 778-329-9290
Email: kasia.hajduk@altusgroup.com

The Grosvenor Building
1040 West Georgia Street
Suite 630
Vancouver, BC V6E 4H1
www.altusgroup.com



Altus Group is Canada's leading provider of independent real estate consulting and advisory services. Services provided include real estate appraisals, preparation of developers cash flow projections, property purchase due diligence, expropriation and litigation support, insurance appraisals, construction cost consulting (estimating, planning, monitoring), assessment/realty tax consulting, land surveying, and Urban and Real Estate Economic Studies. We have over 1,200 employees and a national network of 31 offices in 23 cities throughout Canada and 6 offices throughout the UK

The information contained herein was obtained from sources deemed reliable. While thought to be correct, it is not guaranteed by Avison Young Commercial Real Estate (BC) Inc.

Avison Young Commercial Real Estate (B.C.) Inc.

VANCOUVER
#2100 - 1055 West Georgia Street
PO Box 11109, Royal Centre
Vancouver BC V6E 3P3
TELEPHONE: (604) 687-7331
FAX: (604) 687-0031
www.avisonyoung.com

For more information please contact:
Douglas McMurray
Managing Director
Direct Line: (604)-647-5082
dmc Murray@ay-bc.com

Avison Young Industrial Team

Rob Gritten
John Lecky
Greg Lane
Ross Marshall
Michael Allen
Struan Saddler
Josephine Kwan

VANCOUVER
CALGARY
EDMONTON
REGINA
WINNIPEG
TORONTO
MISSISSAUGA
OTTAWA
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