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Are developers missing a swing to strata?

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Sales and marketing agents Sarah McPhee and Allan De Genova at Wesgroup Properties' Brewery District in New Westminster: doctors, medical specialists and investors have bought 70 per cent of the strata office space.

Demand for commercial strata growing but few developers are willing to sell retail or office space

BY FRANK O'BRIEN

When the BC College of Physicians and Surgeons purchased nearly three floors - about 25,000 square feet - in Delta Land's Hotel Georgia office tower this year it revealed the height of the frustration - and demand - in the commercial strata sector.

"I get five calls a week from doctors looking for strata office space," said Matt Walker, senior associate at Avison Young in Vancouver. Doctors, he said, are among the professional tenants tired of paying landlords' operating costs and ever-higher lease payments. He said most of the doctors calling are looking for space along the Broadway Corridor where "they are captive tenants" due to the proximity of the Vancouver General Hospital.

The office vacancy rate on the Corridor is around 5.5 per cent and lease rates for Class A space are as high as \$30. Add in gross occupancy costs and the price rises to nearly \$40 per square foot. This may explain why Lululemon Athletica bought 1818 Cornwall Avenue in the Corridor recently for \$65 million.

At the Georgia tower, the doctors would have paid north of \$500 per square foot for 7,000-to-8,000-square-foot floor plates in one of the top mixed-use office towers in the city. Their bulk purchase took nearly a third of the 71,000 square feet of Class AAA space in the tower.

The Jameson House mixed-use tower on West Hastings, by Bosa Properties, has already sold out half of its 61,000 square feet of offices in a building that won't complete until next year.

In North Vancouver, Up Country Developments, owners of the Westmark building on West 1st Avenue, changed the 125,000-square-foot office space to strata when the anchor tenant moved out.

Still, of the 700,000 square feet of substantial new office space being built in Metro Vancouver, less than 135,000 square feet is strata space, and the ratio in the retail sector is even lower. Yet, the demand for commercial strata has been apparently outstripping demand for years.

Last September, business mogul Thomas Fung sold \$80 million worth of retail and office space in his expanded Aberdeen Centre mega-mall in Richmond in three days. The lineup of mostly Asian buyers stretched for a half a block on the sale's opening day.

And Fung showed another side to the strata angle: the Royal Bank of Canada is Aberdeen Centre's anchor tenant. The bank signed a lease for 5,000 square feet of space in a unit that Fung then sold to an unidentified investor.

In fact, estimates are that more than half the Aberdeen space sold went to investors, not owner-users.

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HST edge

If the harmonized sales tax (HST) should survive a public vote this year, it could prove a boon to those selling commercial space, Fung noted. "The HST does not apply to commercial properties like strata units in malls or office units," Fung said, "Right there, that's a saving of 12 per cent. You have to pay the HST on commercial leases."

There are very good reasons why there is not a lot of strata commercial space, according to Walker. "There is not a deep market of buyers," he said.

Most office tenants, he said, like the flexibility offered by leasing and "would rather spend money on their business than on bricks and mortar."

Also, he said, a cost analysis of buying versus renting often favours leasing, even with the potential of equity returns. "The net rent is less under a lease," he said.

Smaller investors

Walker doubts that there is much demand for smaller investors in the commercial strata market, because the high prices for commercial property - around \$400 to \$700 per square foot depending on location - make it difficult to achieve positive cash flow.

As well, unlike a residential unit, it can take months, not days, to lease out an office or retail space if a tenant vacates. Also, financing for strata commercial can be difficult to access. Lenders often require a down payment of from 30 per cent to 40 per cent. On a \$500,000 commercial strata, for example, an investor would have to put at least \$150,000 down and also pay for an appraisal, building inspections, loan fees and other costs.

There are also tax issues to consider. Businesses routinely can deduct the full amount they pay in rent. Owners of rental property can write off repairs immediately, but improvements to commercial real estate have to be deducted over a number of years, the same with depreciation on commercial buildings. The buyer can deduct interest on the purchase loan, property taxes and other qualifying expenses, however.

Large developers see commercial buildings as providing steady, long-term income from leases, not the quick cash of strata sales, which will likely keep stratas a niche opportunity.

Doctors a niche

For doctors and dentists, however, who need to improve premises to specific needs and want to secure a precise location, buying rather than leasing can be attractive.

This is seen in New Westminster, where Wesgroup Properties is selling office space in its new nine-acre Brewery District. The under-construction site includes retail, offices and condominium residences.

Due to its proximity to the Royal Columbian Hospital, the strata space is dedicated to the medical community, offering a mix of flexible spaces, exclusive doctor parking and direct access to the hospital. Allan De Genova of Focus Real Estate Marketing, which is handling sales, said one medical specialist bought an entire floor, and other doctors have taken 800-square-foot-to-2,000-square-foot spaces.

De Genova said his last six sales were all investors, who took smaller office spaces that share a central lobby and reception area. This space will likely be leased to doctors. "Investors see it a blue-chip play," he said.

He added that it is not only physicians who are buying space, but those providing medical supplies and services.

Prices for the Brewery office strata are around \$680 to \$700 per square foot for fully fixtured offices, and 70 per cent of the 50,000-square-foot building is sold out.

Yet Gino Nonni, president and CEO of Wesgroup Properties, does not see a lot of strata commercial in Wesgroup's future. "The Brewery District offered a niche opportunity for the medical community," he said, adding Wesgroup will still lease out the bulk of its commercial space.

For instance, the 280,000-square-foot BC Transit offices being built at the Brewery will be leased space, a deal brokered by Avison Young, and will be owned by Wesgroup, as will the 30,000-square-foot Thrifty's grocery store and other leased retail space.

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