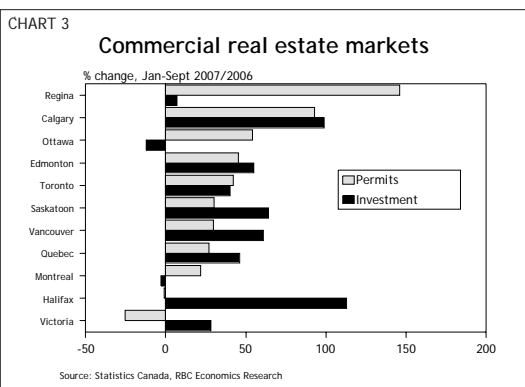
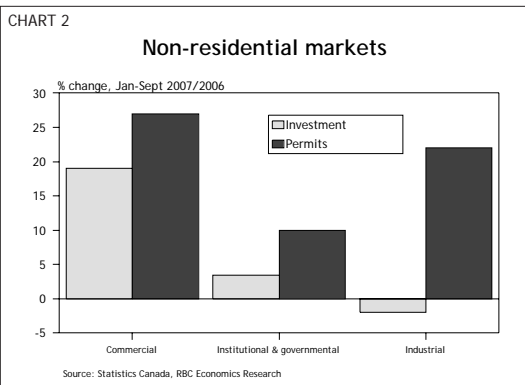
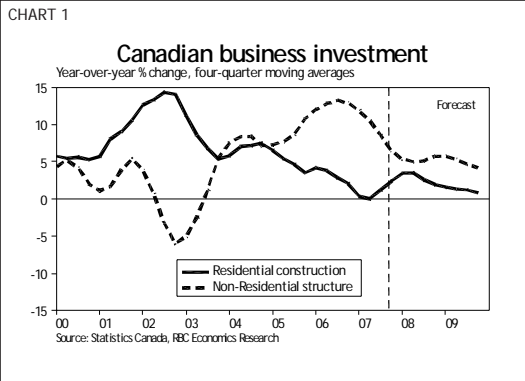


COMMERCIAL REAL ESTATE MARKET MOMENTUM POISED TO SOFTEN

November 2007



The current cycle's momentum in both residential and non-residential real estate markets now appears to have peaked with a slowdown expected over the coming quarters (chart 1). Commercial markets have had a strong run in the current cycle, but the momentum is expected to soften during the next year alongside an overall slower economic growth profile in both Canada and the United States. As more supply of commercial properties reaches the market, some of the current pressures on existing capacity will ease. On the business side, there are stresses facing Canadian corporations, including a sharply stronger Canadian dollar, tighter credit conditions that imply slightly greater restraint on business investment in the near-term, a rising cost environment due to labour shortages and higher input costs, and a housing-led slowdown in the U.S. economy that will continue to reduce demand for many Canadian goods and services. All combined, these stresses will slow the pace of corporate profit growth and contribute to a slowdown in commercial construction markets.

Non-residential investment to slow but not stall

Non-residential investment clocked in a 13% growth pace in 2006. The build-up of strong demand coupled with significant supply shortages since 2002 created tight real estate markets and spurred a major cross-country construction boom. In reaction to strong demand, there has been a substantial increase in the supply of commercial properties that have come to market in the last few years, with the downtown cores of Toronto and Calgary leading the pack. Commercial markets have responded and have recently started to show signs that they are returning to more balanced positions. As this re-balancing continues into 2008, we anticipate a slowdown in the pace of non-residential investment from last year's double-digit growth to something closer to the 6% range in the next two years. This is still a strong pace, but certainly a moderation compared to the prior few years and signals, in our view, that non-residential construction markets are likely now just beyond their cyclical peaks. However, we are still bullish on public spending prospects, with most provinces expected to get a sizeable capital expenditure lift from the public sector.

Non-residential permits still indicating more strength ahead

The issuance of permits provides a good gauge of forthcoming activity existing in the pipelines. Non-residential permits are up 22% on a year-to-date basis with all three subsectors — commercial, industrial, and institutional and government — posting solid growth in the value of permit issuance (chart 2). The commercial sector alone accounts for roughly 60% of total non-residential investment and has been a critical support to strength in the sector. The commercial sector has led the pace in both permit activity and investment. A year-to-date tracking shows that commercial permits are up 27% compared to the same period last year and actual commercial investment is up 20% with growth broadly spread across cities (chart 3). The high level of permit activity and strong

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CHART 4
Downtown office vacancy rates

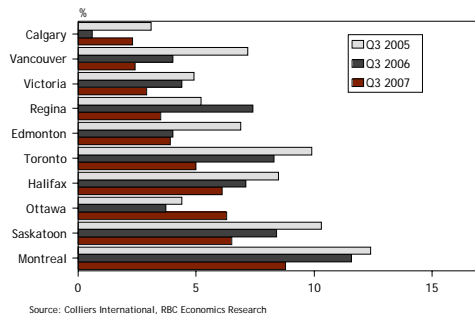


CHART 5
Average annual quoted rent

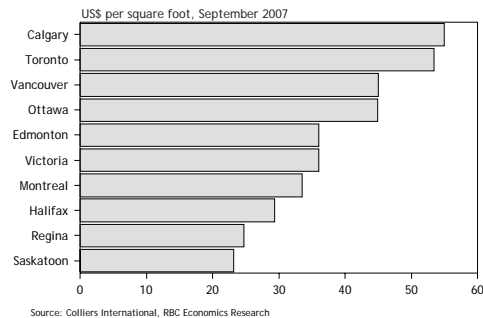


CHART 6
Price indexes of non-residential construction

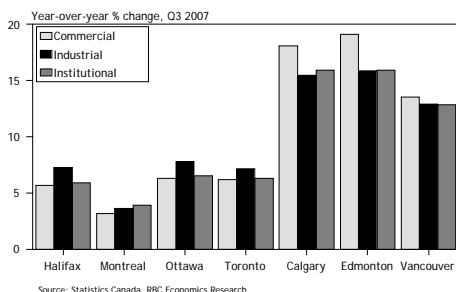
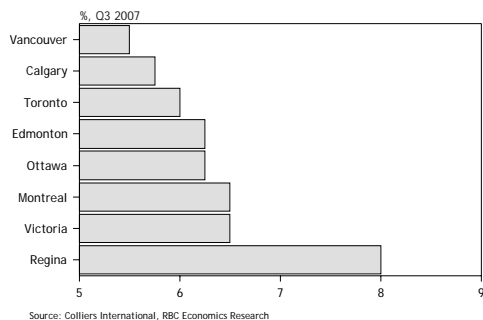


CHART 7
Central business district cap rates



investment patterns demonstrate the strength that still exists in the current business cycle. However, rising costs, increased supply and overall softer economic growth are all expected to contribute to tempering the current momentum in real estate markets.

Land-constrained downtown office markets tight

Office space in the downtown core in many cities has tightened significantly in the last few years. Demand pressures have translated into record-low vacancy rates and rising rental costs in many cities. Vacancy rates in many key cities have been trending lower since 2005 (chart 4), with the majority of the drop in vacancy rates reported through 2006.

On a global scale, Calgary is the only Canadian city that ranks in the top 25 cities for office construction (19th place) and occupancy costs (20th place). The insatiable oil-linked demand for Calgary office space drove the average rental rate for a downtown Calgary office above Toronto's in 2007, making it the most costly market in Canada (chart 5). Vancouver's market still lurks behind both Toronto and Calgary on rental costs for downtown space, but on a valuation basis it remains the most expensive. Capacity pressures in Edmonton's market have seen its rents increase aggressively, placing it middle-of-the-pack among major Canadian cities. What is notable here is that Saskatoon and Regina are still well below average rental costs despite a significant pick-up in their local economies. These two cities are gradually becoming more expensive but, in terms of affordability, still remain at the low end and are well-positioned for strong investment growth in the year ahead.

Labour and supply shortages fuel a rising cost environment

Plunging vacancy rates have exerted sustained upward price pressure on real estate. Inflation has been a growing concern in the current cycle — particularly in Alberta where inflation is tracking at more than twice the national rate. The persistent strength in the non-residential building construction market has caused the cost of labour and building materials to soar (chart 6). The largest year-over-year increases in building costs in the third quarter were reported in Edmonton (up 18%), Calgary (up 17%) and Vancouver (up 13%). It was the commercial component of non-residential construction that led the overall pace of increase. The cost environment in cities in central and eastern Canada was more modest compared to the west but still up roughly 5% year-over-year in the third quarter. Wage growth has also been accelerating as labour shortages pose significant challenges to company operations.

Capitalization rates

Capacity shortages of all types have created a rising cost environment that has squeezed company profit margins. Cost over-runs have become a frequent occurrence in Alberta. Break-even levels on oil sands development projects, for example, have soared and forced some companies to postpone or even cancel potential projects that are no longer economically viable. In order to evaluate quoted rents in the context of their local markets, capitalization rates provide a useful tool to help determine the relative valuation of a property. A capitalization rate is a measure of the ratio between the net operating income produced by an asset (real estate) and its capital cost (current market value of the real estate). Higher operating incomes and/or lower market values will lead to a higher, and therefore more attractive, capitalization rate.

Vancouver has the lowest cap rate among the big cities, sitting at 5.5% (chart 7). The high cost of real estate in Vancouver is reflected in this low cap rate. Calgary is the only other city with a cap rate below 6%. Vancouver has traditionally been an expensive market, but the shift in Calgary's market has been quite dramatic. For comparative purposes, the only cities in the United States with capitalization rates below 6%, and therefore in a comparable range to Vancouver and Calgary, include Boston, Chicago, Los Angeles, New

York City, San Francisco and Washington. Regina's cap rate of 8% shows that it still offers relatively inexpensive office real estate on a valuation basis. The remaining major cities hover between 6%-7%. The attractive capitalization rates and low rental costs in Saskatchewan's market will likely draw strong growth into its commercial market in the coming year, while lower capitalization rates in Alberta and British Columbia will restrain the pace of current activity.

Current economic indicators

Latest month available, year-over-year % change unless otherwise indicated

Cities are ranked in descending order by population size

Census metropolitan area	Job growth Oct-07	Jobless rate Oct-07	Res. permits ¹ Sep-07	Non-res. permits ¹ Sep-07	MLS prices Oct-07	MLS sales Oct-07	Housing starts Oct-07	Downtown office vac (%) Q3 2007	CPI Oct-07	Consumer bnkrpts ¹ Sep-07	Business bnkrpts ¹ Sep-07	Retail sales Sep-07
Toronto	2.5	6.7	9.0	52.8	9.3	10.4	-10.4	5.0	2.5	9.0	7.2	4.0
Montréal	1.8	7.0	8.0	16.5	8.4	12.9	-37.1	8.8	1.7	8.6	33.0	-0.5
Vancouver	1.0	4.2	7.2	-27.9	7.4	11.1	51.8	2.4	1.8	-9.1	26.5	2.3
Ottawa-Gatineau	3.9	5.2	40.6	-1.9	8.6	4.5	12.2	6.3	2.3	-16.2	28.6	na
Calgary	2.8	3.1	3.9	-27.2	9.2	-4.5	31.0	2.3	4.6	1.5	9.8	na
Edmonton	5.6	4.2	8.3	5.1	24.5	-34.1	16.1	3.9	5.4	-18.6	-25.0	na
Quebec	5.3	4.6	38.1	38.7	12.9	0.6	113.4	na	1.8	8.7	-15.4	na
Hamilton	2.5	5.8	-18.7	2.1	11.0	5.2	-18.3	na	na	12.4	5.1	na
Winnipeg	1.6	4.5	34.1	-46.4	na	na	-35.1	na	1.8	1.8	-69.6	na
London	2.3	6.0	-23.6	77.3	6.1	-2.7	-13.5	na	na	5.1	0.0	na
Kitchener	-0.9	5.8	56.2	51.9	5.4	10.6	18.8	na	na	3.9	na	na
St. Catharines-Niagara	0.7	6.8	-31.6	-53.3	3.2	6.4	26.9	na	na	22.7	27.3	na
Halifax	3.0	5.1	59.1	6.8	10.3	13.9	32.1	6.1	2.4	-2.0	-46.9	na
Windsor	-4.8	8.6	-1.8	-62.1	-3.3	-6.3	69.0	na	na	12.5	36.8	na
Victoria	7.0	3.7	-9.6	-0.1	6.9	19.7	-12.1	2.9	0.8	4.9	14.3	na
Oshawa	2.4	6.4	-15.1	-33.6	na	na	-2.4	na	na	-10.5	88.9	na
Saskatoon	5.5	3.9	96.3	64.4	57.8	-5.6	25.2	6.5	4.6	-23.7	8.3	na
Regina	-3.7	5.0	32.6	-64.4	43.1	31.2	27.5	3.5	3.0	-23.7	27.3	na
St. John's	1.7	6.2	69.2	-3.8	6.7	33.6	28.3	na	2.3	-7.1	-33.3	na
Sherbrooke	4.1	5.7	13.1	-43.3	-3.5	-5.5	19.8	na	na	6.3	111.1	na
Greater Sudbury	4.5	5.7	57.1	-0.3	19.0	-6.5	9.8	na	na	-9.3	na	na
Abbotsford	0.8	4.5	-34.2	435.9	na	na	-58.7	na	na	na	na	na
Kingston	11.0	4.7	27.1	106.6	12.2*	18.1*	-69.7	na	na	21.5	-44.4	na
Saguenay	1.3	8.2	66.3	-23.1	19.5	na	25.7	na	na	na	na	na
Trois-Rivières	8.3	7.4	54.0	-30.0	15.4	5.2	228.6	na	na	16.0	-46.7	na
Saint John	11.5	5.4	34.1	-70.6	9.6	22.1	186.7	na	3.2	-2.3	50.0	na
Thunder Bay	4.6	6.3	1.8	7.0	-0.9	9.3	171.4	na	1.4	20.3	140.0	na
Canada	2.5	6.1	14.9	8.0	11.3*	5.8*	-4.9	na	2.3	4.1	-8.5	5.4

*as of September 2007

¹ Three-month trend

Source: Statistics Canada, Industry Canada, Canada Mortgage and Housing Corporation, Colliers International, Canadian Real Estate Association

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