



Current Analysis

Current Analysis reports address current economic issues of importance to RBC Financial Group and its clients.

Non-residential construction gathers momentum

January 2006

There is mounting evidence that residential housing markets are gradually cooling off at the national level. House prices are still appreciating, but the pace of growth is slowing, and new home construction activity is gradually declining across the country. These moderate national trends confirm our view that Canada's housing market is not a bubble about to burst and that prices are comfortably adjusting to more modest demand. Residential construction is still strong in some cities, but we think starts will decline in the year ahead everywhere except in Alberta and British Columbia.

Non-residential construction poised for a takeoff

In contrast to our forecast for a decline in residential construction in 2006 to 1.8% from 7.1% in 2005, we see non-residential investment growth remaining strong and steady at 10.2% in 2006 compared to 11.3% last year.

There is growing evidence that non-residential construction is steadily gaining momentum and has the potential to take up much of the slack from the moderating pace of residential construction. Non-residential permits are piling up in several cities. As well, the large quantity

and value of capital spending projects either ready to begin construction or currently under way across the country are further evidence of gathering strength in non-residential investment. Falling office vacancy rates, rising office rents and record profit growth are additional signals that companies are poised to embark on a new round of investment.

The inventory of major investment plans (see chart) includes all projects that are either proposed, speculative, announced, approved, or currently under construction. Alberta stands out as an outlier in the energy sector, but Quebec and Ontario have the largest capital inventory among all other provinces in other sectors. These investments in Ontario and Quebec are good indicators of a positive business outlook. Manufacturing has certainly suffered a substantial hit from a stronger dollar and spikes in oil prices, but

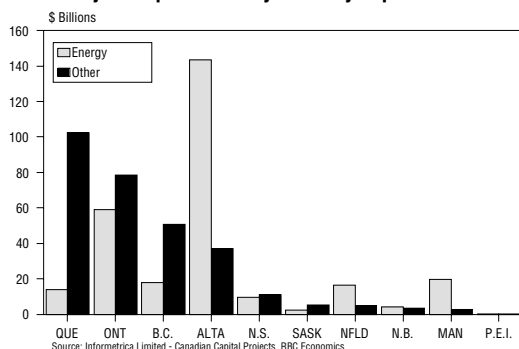
it appears that companies are reinvesting and upgrading their capital, which should help improve overall productivity.

Four western cities strong in both residential and non-residential markets

Vancouver, Ottawa, Calgary, Edmonton, Quebec, Hamilton, Windsor, Victoria, Oshawa, Saskatoon, Regina, Greater Sudbury, Abbotsford, Saguenay and Saint John are all experiencing growth in non-residential permits, with seven of these CMAs experiencing non-residential permit growth of more than 100%.

Strong fundamentals in British Columbia and Alberta should help sustain both the housing and non-residential markets in the coming year. In Alberta, this can largely be attributed to major capital expansion plans under way in the oil and gas sector, including several multibillion-dollar investment projects in the oil sands. In British Columbia, we are seeing the first signs of what will be a major ramp-up in private and public infrastructure projects to feed a booming economy

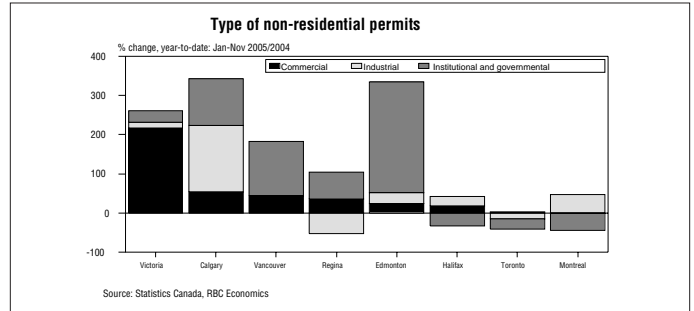
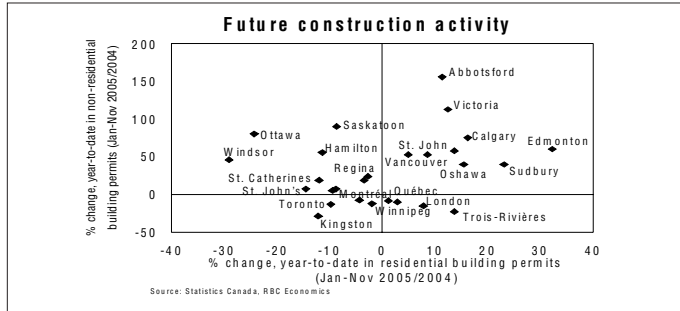
Project expenditure by industry & province



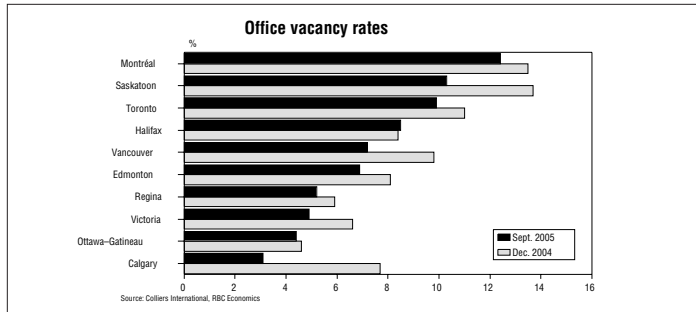
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Non-residential construction

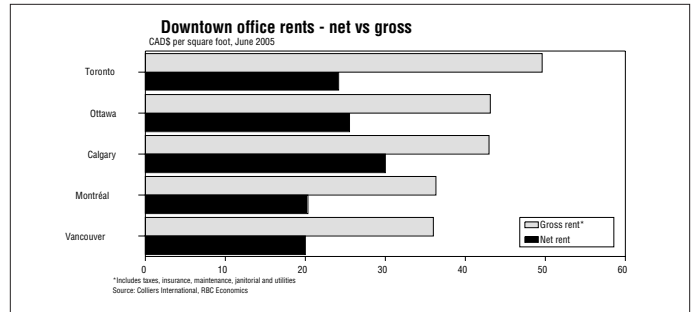
Non-residential construction to fill in behind housing markets. Especially out west...



...where vacancy rates are tighter...



But Toronto is still the priciest.



and to plan ahead of the 2010 Vancouver Winter Olympics. These projects include major sports venues, significant investments in transportation infrastructure like the Port of Vancouver and a major expansion at the Vancouver Airport.

Seven of the 27 CMAAs show positive growth in both types of building permits. Four are in western provinces — Vancouver, Calgary, Edmonton and Regina — with the January to November 2005 dollar-value gains in both residential and non-residential permits well above all other CMAAs. Vancouver and Calgary are showing positive job growth, strength in both residential and non-residential permits, a continued appreciation in MLS housing prices and larger volumes of MLS house sales. Edmonton and Regina are also seeing solid growth in building permits of all types, but posted declines in year-over-year growth in December 2005.

Much of the recent building permit growth in these four cities is coming from the non-residential sector. In fact, the value of Calgary's September to November 2005 commercial permits was up by 125% compared to the same three-month period in 2004. In Vancouver, a steady ramp-up in institutional permits during most of 2005 largely fuelled the gain in their non-residential permits. New construction scheduled in 2006, primarily focused in commercial and institutional markets, will help to supply their tight economies, but not enough to cope with the mounting demand.

Calgary's downtown office rent high, but Toronto's still more expensive to occupy

There seems to be an insatiable demand for office space from companies tied to the oil and gas sector. Calgary has become the hotbed for these companies. Office space is in short supply, wages

are up and office vacancy rates are the lowest in the country. Until this demand is met with increases in supply, vacancy rates will likely continue to plunge.

There is much talk of the rental cost for downtown Calgary office space topping Bay Street numbers, but Toronto downtown office space is still the priciest to occupy in the country. Calgary's annual net rent per square foot for prime downtown buildings is above that of Toronto's, but a much different trend appears when all costs associated with occupying a building (including taxes, insurance, maintenance, janitorial services and utilities) are included. Third-quarter 2005 data show that the average annual quoted gross per square foot cost for a prime downtown building was highest in Toronto at \$49.60, with Ottawa coming in second at \$43, and Calgary third at \$38. Among Canada's larger cities, Edmonton proved to have the cheapest all-in cost at \$19.50 per square foot. The high property tax burden in Ontario is what keeps Toronto at the top of the charts. The Ontario government is downloading many services to municipalities, which in turn are funding themselves mostly through higher non-residential property taxes.

Overall, despite the booming Calgary market, demand for Toronto's office space remains strong. Office vacancy rates can be an early predictor of rising rental costs ahead. Outside of Halifax, third-quarter 2005 vacancy rates were down from their levels nine months ago in all other listed cities. Calgary not only leads the way with the lowest vacancy rate at 3.1%, but also saw the strongest decline during this period, dropping by 4.6%. Falling vacancy rates can put upward pressure on rents and this will certainly be something to watch for in the months to come.