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Canada: Your Next Retail Frontier

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With its cultural similarity, close proximity and urbanized population, Canada is a natural place for retailers, based in the U.S. and other countries, to pursue expansion. A significant number of retailers have successfully expanded into Canada and, as of late, many more are considering it. Recent changes in a number of economic variables have significantly increased the appeal of Canada as a destination for expansion. These economic changes are, in large part, related to the economic downturn and Canada's strong economic performance relative to its G7 peers. Such changes include a strong Canadian dollar and robust consumer spending. Any retailer with its sights set on Canada, however, should also be aware of some of the idiosyncrasies of the Canadian retail landscape that impact expansion plans. By becoming familiar with the retail landscape in Canada and addressing challenges at the outset, U.S. based (and other foreign based retailers) can benefit from expanding into a market with significant opportunities. Canada, in general, and Toronto, in particular, represent suburban and urban retail opportunities for strong international retailers with a history of operational success and the right combination of format and attitude.

The Economic Stars Have Aligned

Canada came out of the economic downturn of 2008 bruised but relatively unscathed, avoiding the deep recession the United States and Europe experienced.[1] According to the International Monetary Fund, Canada continues to outperform its peers.[2] Though Canada does not operate in a vacuum, even the crisis in Europe and feared double-dip recession in the U.S. have not dampened its economic advantages.[3]

For U.S. retailers, the Canadian dollar's value relative to that of the U.S. provides a compelling reason to set up shop in Canada.[4] In September of 2007, for the first time since November of 1976, the Canadian dollar met the U.S. dollar at parity (a significant increase from its all time low of $0.6179 U.S. on January 21, 2002);[5] and for the last couple of years, it has hovered at around parity.[6]

There has also been a rise in Canadian retail spending per capita relative to the U.S. Back in 2004, in Canada, retail spending per capita was 50% lower than in the U.S.[7] Now, per capita retail spending in Canada and the U.S. are equal (in U.S. dollars).[8] Through this can, at least in part, be explained by the strong Canadian dollar, strong consumer confidence has also played a part. Such a large increase in retail spending per capita has provided increased opportunity for retailers.

The numbers reveal that the Canadian retail sector is underserviced, providing ample prospects for growth. The United States has over 23 square feet of shopping center floor area per capita.[9] Comparatively, Canada has 14 square feet of shopping center floor area per capita, resulting in consumers who are significantly underserved.[10] Moreover, compared with average sales per square foot of $309 in the U.S., average sales per square foot in Canada are $540,[11] and there are at least several malls that boast average sales of over $900 per square foot.[12]

The Canadian Retail Landscape: We are Just like You, Only Different

For offshore retailers looking to expand into Canada, it is important to keep in mind certain attributes that are peculiar to the Canadian market. Good local knowledge will inform you and your expansion strategy about a number of important considerations.

LIMITED NUMBER OF REGIONAL MALLS AND LOW VACANCY RATES

Canadian cities have allowed relatively fewer malls to be built since the development booms of 1960s and 1970s.[13] Consequently, there is a premium to be paid for good enclosed mall space. It's Canada and while we do shop in the snow, enclosed malls have their advantages. When compared to Americans, Canadians have 39 percent less mall space.[14] This scarcity in mall retail space has resulted in relatively low vacancy rates. Vacancy rates in major Canadian cities average approximately 3.9 percent.[15] Given the 11 year regional mall vacancy rate high of 9.4% in the U.S., this figure may startle American retailers.[16]

CONCENTRATION OF OWNERSHIP

With high per square foot sales, excellent demographics and customer flow, Regional Malls in Canada[17] represent some of the most desirable spaces for large retail chains. This situation has bestowed significant leverage upon the owners of such properties vis-à-vis retailers who are eager to obtain space. In addition, the concentration of ownership in a relatively small number of landlords with national portfolios[18] has further tilted the negotiating table in favor of landlords.

Alternatives to the regional malls include the smaller shopping centres, the super centres, standalone buildings and strip malls. There is, however, a relative concentration of ownership in these structures as well.[19]

Concentration of ownership will not end in the near future. In the best markets in Canada, sky high land prices are inhibiting the construction of new developments. More commonly, existing malls are being bought and sold among established market players with large portfolios.[20]

Concentration can, at least in some ways, be a good thing. For example, new concepts can role out on a national basis more easily by partnering with a few experienced and successful landlords.

GREAT SPACE COMMANDS GREAT RENT: AT LEAST THEY SAY IT DOES

The discussion so far translates into Canada being a great opportunity for foreign based retailers. But it is not cheap. The basic rent, operating costs and taxes, on a comparative basis, can add up to very high gross rent commitments. All of the factors mentioned above often result in sticker shock. In the top Canadian markets, such as Toronto and Vancouver, retailers can expect to find rents on par with cities like New York and Chicago when you factor in higher operating costs and taxes. Retailers struggle with business plans and rent ratios that require very high revenue numbers to justify a deal. They do not always naturally jump to the conclusion that prices should be raised.

LEASE TERMS

Landlord precedent leases are well drafted and well-travelled, leaving little to the imagination or chance. Retailers must be wary of offers and proposals that may be binding. When negotiating lease terms, large retailers who may be accustomed to getting what they want have a harder time than they expect. On the positive side, if you can negotiate co-tenancy requirements to backstop the high rent, the low vacancy rates make starting vacancy levels at the 75%-80% level reasonable.

Options for Retailers to Enter the Canadian Market

Limited numbers of Regional Malls and low vacancy rates may present an obstacle for American, Asian and European retailers that wish to expand into Canada. Aside from gaining access to the Canadian market by entering an existing shopping center, retailers may be able to come into Canada by acquisition or by entering one of the new shopping center developments that are on the horizon. For those who prefer to first test the waters, subletting space within another major retailer or department store may be an option.

ENTRY BY ACQUISITION

In 1994, Walmart utilized the strategy of acquisition to gain entrance to the Canadian market when it acquired Woolco stores. Recently, rival Target followed the same path, acquiring up to 220 Zellers stores from the Hudson's Bay Company for $1.8 billion.[21] By acquiring the leasehold interests of an existing major tenant, a retailer overcomes the issue of limited space in existing shopping centers and sometimes exclusive and assignment issues. Acquisition as a means to enter the Canadian retail market has not been limited to the likes of Walmart and Target. Limited Brands (owner of Victoria Secret and Bath & BodyWorks, among other brands), too entered the Canadian retail market by acquiring La Senza.[22]

Although acquisition may eliminate issues related to limited retail space and provide retailers with a head start on other retailers eager to come to Canada, acquisitive retailers should also understand they are inheriting all of the attributes of potential targets. In the case of Target, 15 of the stores it acquired are unionized and Target could be deemed the "successor employer", leaving the existing union intact.[23] Significantly, if a retailer acquires an existing company (unlike the case of Target, where specific leasehold interests were acquired from Zellers), it acquires all the locations—not just the good ones. So when acquiring a Canadian target, robust due diligence is necessary.

NEW DEVELOPMENTS AND EXPANSIONS

Despite the cost of property, high rents and strong covenants will support some new developments. These new developments may also provide an opportunity for retailers looking to enter the Canadian market. In 2011, two deals to build U.S.-style premium outlet malls in Halton Hills (a suburb outside Toronto) were announced. The first is set to be built in conjunction with a $1-billion joint venture deal between Tanger Outlet Centers Inc.[24] Calloway REIT recently announced the opening of a second premium outlet mall just west of the Tanger-RioCan site.[25] Tanger and RioCan have also teamed up to purchase 50 acres of land in Kanata, Ontario (near Ottawa) to develop an outlet mall and recently purchased Cookstown Outlet Mall in Innisfil, Ontario, with potential to expand from approximately 161,000 square feet to approximately 320,000 square feet.[26] The Tanger-RioCan outlet strategy will help provide space for retail tenants.

TEST THE WATERS

Rather than jump in with both feet, retailers may prefer to dip their toes in the Canadian market first. Britain's Topshop recently entered the Canadian market by establishing a capsule within The Bay.[27] This approach allowed Topshop to enter the market without having to locate in independent space. From the perspective of The Bay, the arrangement is also appealing because it will likely lure new customers to the department store. This option, however, creates a new level of complication with subletting agreements and branding issues.

The Greater Toronto Area: Urban and Suburban Retailing

The first destination for foreign retailers who wish to enter the Canadian market will likely be the Greater Toronto Area (GTA). Often this represents a continuation of the strategy of expansion into cities already well under way in Europe, Asia or the U.S. The GTA is the most populous metropolitan area in Canada, with a population of approximately 5.7 million people.[28] Within the city limits, the population is approximately 2.5 million.[29] It is a vibrant, growing area that is rich in diverse cultures and tastes. Toronto has many factors to support it as an urban retail opportunity.

The city is home to Union Station, the busiest transportation Hub in Canada, serving over 200,000 people per day going to work in the healthcare, education, entertainment and financial industries. Union Station is the southern anchor of the world's largest underground shopping complex known as *The Path*. Within *The Path's* 27 kilometer (17 mile) complex are 1200 shops

and services occupying 4 million square feet of retail space linked to over 50 buildings, 5 subway stations, 20 parking garages and Union Station. *The Path* provides a unique retail experience for over 100,000 commuters per day, tourists and a large number of people who reside in downtown Toronto.

Anchoring *The Path* to the north is Bloor Street with a bevy of high end retailers.[30] In between Union Station and Bloor Street, you find unique and well defined neighborhoods such as the eclectic Queen Street West, the sassy Dundas Square (Toronto's own Times Square) and the ultimate destination shopping experience at the Toronto Eaton Centre, Toronto's largest downtown mall with over 230 retailers and services. Go a few miles north and watch the traffic back up on the highway trying to get into Yorkdale Shopping Centre, one of the best malls in Canada in sales per square foot. The vibrant shopping and restaurant scene is only improving as Toronto continues on a residential condominium, hotel and office tower building frenzy.

Proceed with Intent

Opportunity comes with varying levels of risk. A favorite saying is that "it is better to be a settler than a pioneer, because pioneers collect all the arrows". Canada and Toronto, in particular, are well settled retail frontiers with friendly inhabitants. For retailers looking for a new market to expand into, Canada is a great place to look. This article attempts to provide an understanding of the environment in which incoming retailers will have to negotiate. Those with a fantastic brand and business model should come in boldly. Opportunities and space are always available for top notch retailers with great products and services. It is up to you, as the retailers, to present compelling visions and formats and provide the justification for a better deal. Be a preferred retail client offering a superior combination of attributes to landlords that other retailers cannot, such as multiple leases, large formats, increased ability to draw traffic, synergies with existing retailers, a strong covenant and operational history of success. When opportunities and space are limited and competition is robust, it is easy to get crowded out, but there is always room at the top.

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[1] See "The Goldilocks recovery" *The Economist*, May 6, 2010, *available at* http://www.economist.com/node/16060113.

[2] See "Canada's economy out performs peers, says IMF" *The Toronto Star*, October 31, 2011, available at http://www.thestar.com/business/article/1079101--canada-s-economy-out-performs-peers-says-imf; see also "IMF says Canada faring better than others in the G7" The Globe and Mail, October 31, 2011, *available at* http://www.theglobeandmail.com/report-on-business/economy/growth/imf-says-canada-faring-better-than-others-ing7/article2219969/.

[3] See "Still safe and sound?" *The Economist*, August 10, 2011, *available at* http://www.economist.com/blogs/americasview/2011/08/canadas-economy; see also 'Canada's Economy Rebounds Faster Than Forecast on Exports" *Bloomberg Businessweek*, November

30, 2011, *available at* http://www.businessweek.com/news/2011-11-30/canada-s-economy-rebounds-faster-than-forecast-on-exports.html.

[4] "The Retail Report Canada, Spring 2011 Edition" *Colliers International* at 1, *available at* http://www.collierscanada.com/~/media/Files/Research/2011/The%20Retail%20Report%20-%20Spring%202011.ashx; Dr. Sherry Cooper, "Canadian Retailing: A Changing Picture" *Economic Research*, BMO Capital Markets, May 10, 2011 at 8, *available at* http://www.bmonesbittburns.com/economics/focus/20110520/feature.pdf.

[5] "Topsy-turvy world last time loonie was on par with greenback" *Canadian Press*. September 20, 2007, *available at* OANDA, Historical Exchange Rates from 12/21/2001 to 02/21/2002 *available at* http://www.oanda.com/convert/fxhistory?lang=en&result=1&date1=12%2F21%2F01&date=02%2F21%2F02&date_fmt=us&exch=USD&exch2=CAD&expr=EUR&expr2=USD&margin_fixed=0&format=HTML&SUBMIT=Get+Table.

[6] See Bank of Canada, Exchange Rates, 10-year currency converter, *available at* http://www.bankofcanada.ca/rates/exchange/10-year-converter/.

[7] See The Retail Report, supra note 4 at 2.

[8] Id.

[9] Id.; See Canadian Retailing: A Changing Picture, supra note 4 at 1.

[10] Id.

[11] Id.

[12] The following Canadian malls have average sales of over $900 per square foot: Chinook Centre, Oakridge Centre, Pacific Centre, Rideau Centre, Sherway Gardens, Toronto Eaton Centre and Yorkdale Shopping Centre. "The U.S. Retail Experience in Canada" *Presented to: Lexpert Conference November 24, 2011* by Tim Sanderson and Dianne Lemm of Northwest Atlantic.

[13] "Canadian malls growing in only one direction" *The Globe and Mail*, June 20, 2011, *available at* http://www.theglobeandmail.com/report-on-business/industry-news/property-report/canadian-malls-growing-inonly-one-direction/article2068044/print/.

[14] Id.

[15] See "Real Estate Market Update, The Real Estate Industry, 2010 a look back; 2011 a look forward" Altus Group, January 17, 2011 (taking an average of the vacancy rates of Vancouver – 3.1%, Edmonton – 3.2%, Calgary – 2.8%, Winnipeg – 2.6%, Toronto 3.8%, Ottawa – 2.9%, Montreal – 5.1%, and Halifax – 7.8%).

[16] "U.S. mall Q3 vacancy rate at 11-year high" *Reuters*, October 7, 2011, *available at* http://www.reuters.com/article/2011/10/07/usa-retailproperty-idUSN1E7951XL20111007.

[17] Malls [r]anging in size between 28,000 m² to nearly 140,000 m² (300,000-1.5 million sq ft), [drawing] customers from a 10- to 50-kilometre radius, designed to serve a trade area of 200,000 people and over." See Pierre Bioron and Claude Boiron, *Commercial Real Estate Investing in Canada*, John Wiley & Sons, February 12, 2008, 15.3.3(b).

[18] Major owners include the following: RioCan REIT, Cadillac Fairview, Ivanhoe Cambridge, Calloway REIT, Oxford Properties, Primaris Retail REIT and Morguard Investments Ltd.

[19] Major owners include the following: RioCan REIT, First Capital Realty Inc. and SmartCentres Inc. (formerly First Pro Shopping Centres)

[20] See "The Big Get Bigger" *Shopping Centers Today*, November 2005, *available at* http://www.icsc.org/srch/sct/sct1105/feat_special_report_top50.php.

[21] "Target Moves Into Canada By Buying Store Chain" *The New York Times*, January 13, 2011, *available at* http://www.nytimes.com/2011/01/14/business/global/14target.html.

[22] "La Senza sold for $710M" *Financial Post*, *available at* http://www.financialpost.com/story.html?id=973f99f9-a2da-467a-bff7-3da27306276c.

[23] "Target digs in heels as labour union applies to keep unionized status" *The Globe and Mail*, November 28, 2011, *available at* http://www.theglobeandmail.com/report-on-business/target-digs-in-heels-as-labour-union-applies-tokeep-unionizedstatus/article2252737/?utm_medium=Feeds%3A%20RSS%2FAtom&utm_source=Home&utm_content=2252737.

[24] "Tanger, RioCan to launch upscale venture" *The Globe and Mail*, January 24, 2011, *available at* http://www.theglobeandmail.com/globe-investor/tanger-riocan-to-launch-upscale-venture/article1881072/email/.

[25] "Ontario to get second luxury goods mall" *Financial Post*, May 24, 2011, *available at* http://business.financialpost.com/2011/05/24/riocan-and-calloway-race-to-open-outlet-malls/.

[26] "RioCan Real Estate Investment Trust and Tanger Factory Outlet Centers, Inc. Announce Agreements to Acquire Cookstown Outlet Mall and a Site Near Ottawa" *Market Watch*, November 21, 2011, *available at* http://www.marketwatch.com/story/riocan-real-estate-investment-trust-and-tanger-factory-outlet-centers-incannounce-agreements-to-acquire-cookstown-outlet-mall-and-a-site-near-ottawa-2011-11-21-82250.

[27] "Why having Topship in Canada rocks" *The Globe and Mail*, October 8, 2011, *available at* http://www.theglobeandmail.com/life/fashion-and-beauty/fashion/fashion-features/why-having-topshop-in-canadarocks/article2191946/.

[28] Population of census metropolitan areas, Statistics Canada, September 23, 2011, *available at* http://www40.statcan.gc.ca/l01/cst01/demo05a-eng.htm.

[29] Population and dwelling counts, for Canada, provinces and territories, and census divisions, 2006 and 2001 censuses - 100% data, Statistics Canada, November 05, 2008, *available at* http://www12.statcan.ca/english/census06/data/popdwell/Table.cfm?T=702&SR=26&S=0&O=A&RPP=25&PR=35&CMA=0.

[30] Bloor Street (also known as the “Mink Mile”) is comparable in many ways to Fifth Avenue in New York City and the Magnificent Mile in Chicago.

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