Final Report

Prepared by Hemson for the City of Toronto

Review of Applications under the IMIT Property Tax Incentive Program

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Executive Summary

The City of Toronto's Imagination, Manufacturing, Innovation, and Technology (IMIT) Program provides property tax grants to eligible landowners to support new non-residential building construction. The objective of the program is to help provide new space at a lower cost to tenants in targeted sectors and in areas across the City. The City's 2012 Community Improvement Plan (CIP) By-laws, under which the subject applications have been made, provides for the IMIT Program and, where the construction value of the building exceeds $150 million, the grant requires City Council approval. The City has received three applications from Cadillac Fairview related to the proposed East Harbour development, and wishes to bring the submissions forward for Council's consideration in 2023.

Hemson was retained to undertake the review and analysis of the applications in order to assist City staff in making recommendations for Council's consideration. This report summarizes the results of the application reviews. As discussed later in the report, the degree of uncertainty regarding the timing and project details regarding two of the applications, Buildings 1A and 2A, are such that it would be inappropriate at this time to commit the City to providing grants, but the applications could be reconsidered at a later date.

The review of the third East Harbour application (Building 1B) was framed by the following key considerations:

- The overall objectives of the 2012 City-wide CIP By-laws;
- The key assumption that "but for" the IMIT grants, the development project would not occur;
- The City's broader land use planning objectives;

- Infrastructure benefits that the development project will bring to the City;
- Other fiscal considerations such as the scale of the grants as well as anticipated long-term City property tax revenues; and
- The market context applicable to the development project, including the long-term impacts on office demand brought on by shifts in office working arrangements.

A summary of the results of these reviews is provided in the following table:

East Harbour - Building 1B	
Description	▪ 44-storey, 1.3 million sq. ft. office building. ▪ Located on the west side of the East Harbour site, close to the future transit hub
CIP Objectives	▪ Supports many CIP objectives related to preservation and promotion of employment areas ▪ Brownfield remediation ▪ Improvement to underutilized space
"But For" Test	▪ Grant may be a significant factor
Land Use Planning Objectives	Will help to establish East Harbour as a key employment node, supported by higher order transit.
Community Infrastructure Benefits	Benefits to be provided as part of broader East Harbour commercial development: ▪ Public art ▪ Public realm landscaping above flood protection landform ▪ Affordable Incubator employment space ▪ Cultural community space (25 years) ▪ Contributions to offsite affordable rental housing, community services and facilities These benefits remain subject to ongoing negotiations.
Other Fiscal Considerations	Total grants estimated to be approx. $76M vs. net new City tax revenues of $25M over grant period (in 2022$).
Market Context	▪ No precedent for major office development in this area ▪ Long-term outlook anticipated to be strong with introduction of rapid transit
Project Status	▪ Official Plan and Zoning By-laws amended 2018 ▪ Draft Plan of Subdivision application submitted Dec. 2016, targeting approval March 2023. ▪ Site Plan Application submission April 2022 ▪ Construction timeframe anticipated 2024-2028 ▪ Anticipated occupancy date Oct. 2028
Conclusion	Project meets program criteria for IMIT grant.

1. Introduction & Background

The following provides background and context related to the IMIT Program and the review of the three applications under consideration.

A. The IMIT Program & CIP By-Law

The City of Toronto's Imagination, Manufacturing, Innovation, Technology (IMIT) Property Tax Incentive program was established in 2008 in response to slow employment growth in the City compared to other Greater Toronto Area municipalities. It was designed to support Toronto's key industry sectors, to promote employment growth and economic development, and to improve the development potential of the City's many contaminated sites.

Eligibility for the IMIT program is based on targeted employment sectors and land uses. The incentive program provides an annual Tax Increment Equivalent Grant (TIEG), typically capped at 60 per cent of the cumulative municipal tax increment for the new development over a 10-year period. The program also includes the Brownfield Remediation Tax Assistance (BRTA) program, which provides an incentive to support the remediation of contaminated land associated with development projects for employment uses (excluding retail uses). Enhanced grant amounts are also available for eligible development projects in Employment Areas.

IMIT grants are provided on a declining basis over the 10-year period and help offset some of the initial one-time costs associated with new buildings and to attract first tenants. It is common practice that for tenant-occupied buildings, especially offices, the tax incentives are passed on to tenants, resulting in lower gross rents. For office building owners and developers, the grants serve as a useful tool in helping to secure tenants.

The three applications that are the subject of this review were made under the City's previous (2012) by-laws, rather than the now inforce 2018 CIP By-law[1]. Grants are administered through Community Improvement Plan (CIP) by-laws for three areas: Citywide, Waterfront, and South of Eastern. Under these CIP by-laws, in cases where the construction value of a building will exceed $150 million, an application for the grants will require City Council approval. Council is not obligated to approve grants for any project regardless of whether it otherwise meets the eligibility requirements of the relevant CIP by-law. It is noted that the CIP by-laws do not include any provisions for the award of partial IMIT grants.

Since the program was introduced, Toronto's economic climate has experienced significant change. In particular, the City's core has become the focal point for new office development in the GTA. This factor was considered in the 2018 review of the IMIT Program and resulted in a number of significant changes to the program, including elimination of office development eligibility in the Financial District, as well as a proposed reduction in the grant amounts offered in the Queen/Carlaw (East Harbour) and King-Liberty SmartTrack Station Areas.

B. Applications for Review

This report considers three applications for IMIT grants, each involving projects with a construction value of over $150 million. The applications are for major office buildings within Cadillac Fairview's proposed East Harbour development.

In order to assist Council in its decision-making process, the City has requested Hemson to review these applications in the context of the objectives and intent of the applicable (2012) South of Eastern CIP By-law,

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[1] The City's current 2018 CIP By-law was under appeal to the Ontario Land Tribunal and did not come inforce until October 2022

broader City objectives, and the current and projected market conditions. All of the applications meet the basic eligibility requirements as set out by the CIP By-law.

C. Report Structure

This report sets out the overall basis for the review and the key considerations that were taken into account, and provides opinions and conclusions for Council's consideration. It is structured as follows:

Section 2 describes the key considerations and evaluation criteria, which formed the basis of the review.

Section 3 summarizes the results of the review of each application, along with Hemson's opinion as to whether the application meets the criteria considered for the grant.

Section 4 concludes the report with a summary of the findings.

2. Key Considerations

This section reviews the key considerations, which form the basis of the evaluation. Each application is measured against these key considerations as set out in Section 3.

A. Policy & Planning Context

The City's CIP By-laws are guided by the objectives of the City's policy and planning framework, including the Official Plan and secondary plan polices.

i. The IMIT Program CIP By-law Objectives

As stated in the South of Eastern CIP By-law, the primary objectives of the program are to "encourage brownfields remediation and the development of certain employment uses in the City". Broader objectives identified by the by-law that are relevant to this review include:

- Help Toronto meet its employment targets as per the City's Official Plan and the Province's Growth Plan for the Greater Golden Horseshoe;
- Encourage intensification of employment areas through expansion and new development;
- Promote economic development and competitiveness with an appropriate mix and range of employment, opportunities for a diversified economic base, protection and preservation of employment areas for current and future use, and necessary infrastructure to support current and projected needs;
- Support the remediation of contaminated sites for future employment use;

- Support diverse employment areas that can adapt to changing economic trends;
- Enhance Employment Areas to ensure they are attractive and function well by revitalizing those which may be experiencing decline, promoting the distinctive character or specialized function of Employment Areas, facilitating the development of vacant lands, and creating comfortable streets, parks and open spaces, and landscaped streetscapes;
- Encourage key clusters of economic activity;
- Protect employment land for employment uses;
- Promote development of key sectors; and
- Improve the built form and physical character of underutilized spaces.

Each application was reviewed in the context of these objectives.

ii. The “But For” Test

The IMIT Program operates under the general premise that “but for” the grants, the investment would not occur. Hence, the grants are notionally being paid from tax revenue that the City would otherwise not receive. Notwithstanding this requirement, there is no universally accepted “but for” test and therefore it is necessary to use an approach that takes account of the program objectives and the characteristics of the development projects being evaluated.

For the purposes of this review, the “but for” test has been considered in relation to the broader market context in addition to the individual project. A strong office market would indicate that irrespective of whether or not an individual project proceeds, there is sufficient demand that the City will see growth in new space in future years. Conversely, where market conditions do not favour office development, the grants may play a role in “tipping the scales" toward office development over residential development, for example.

For the individual assessment, costs and revenues were evaluated without the IMIT grants in order to determine the potential impacts of the grants on development viability, as well as the overall performance of the project against typical development industry targets. In order to perform this analysis, access to sensitive financial details about each application was essential. Hemson worked closely with the applicant to gather information regarding the projects including estimated capital costs, anticipated revenues and expenses, and details of the applicant's pro forma analysis related to the projects. Information of this type is extremely sensitive and was provided on a confidential basis.

Typically, IMIT grants are passed on directly to tenants. For the purposes of this review, the "but for" financial analysis assumes that in the absence of IMIT grants, notionally lower net rents would be charged by the owner in order to secure tenants, and/or lease-up periods would be longer due to the challenges of securing tenants at higher rent rates. These assumptions were developed by Hemson and discussed with the applicant.

Again, it is important to note that comments regarding development viability and the impact of the IMIT grants included in this report are general in nature due to the confidentiality of the data provided.

iii. Land Use Planning Objectives

Non-residential development is essential to the fiscal health and vitality of the City. As such, Toronto is actively working to encourage a variety of non-residential development and employment through various policy initiatives. The IMIT applications were reviewed within this land use planning context.

Importantly, all three applications are located in an Employment Area as per the City's Official Plan, though it is recognized that a recent Minister's

Zoning Order (MZO) will allow for significant residential development on the East Harbour site. City planning policies emphasize the importance of preserving the City's Employment Areas and the manufacturing sector. The City's Official Plan recognizes that conversion of Employment Areas to other land uses, such as residential development, results in a reduction in land that supports economic activity and that is difficult to regain. City planning policies are structured to protect these employment uses, as well as support growth of key economic clusters in strategic locations.

iv. Community Infrastructure Benefits to the City

The review considered broader benefits to be paid for by the applicant that each development is expected to bring to the surrounding community and City. For example, new publicly accessible open space, and other public realm improvements or amenities, which may not have otherwise, have been provided.

v. Other Fiscal Considerations

The review also considered the anticipated scale of the IMIT grants in the context of the long-term property tax revenues that the proposed development projects would be expected to bring to the City.

It is important to note that the City currently exempts above ground floor non-residential space from development charges. Given the scale of the projects considered in this report, this exemption would represent substantial savings to each of the three buildings and an equivalently large amount of foregone revenue for the City.

B. Market Context

Each IMIT application was reviewed against the current and projected market context. Key market considerations are described below.

i. Toronto Employment Trends

City of Toronto's annual employment survey, released in May 2022, shows employment trends which remain largely unchanged from the previous year. 2020 marked the largest single year decline of total jobs since initiation of the survey in 1983 at 7.6 per cent from 2019. While last year showed some recovery from the 2020 low, growth from 2021 to 2022 shows total employment in the City of Toronto remaining stagnant (0.1 per cent increase).

Like many cities worldwide, changes in employment in Toronto due to COVID-19 were not uniform across sectors. Manufacturing and service employment have declined by 1.7 per cent since 2020, while institutional and office employment has increased at 0.9 per cent and 0.7 per cent respectively since then. While forced closure of businesses is certainly the primary cause for the initial losses, the slower than anticipated return to working in office into 2022 has resulted in lighter foot traffic and has undoubtedly contributed to sluggish employment growth in the City.

As in prior years, the office employment category continues to be Toronto's largest employment category accounting for over half of all jobs (51.5 per cent). Toronto's downtown also continues to hold a sizable portion of all employment (43 per cent).

ii. Trends in Construction Costs

The COVID pandemic and broader supply chain issues have significantly affected the construction sector. Statistics Canada released its latest non-residential construction price index on November 1st, 2022, which reported a 15.6 per cent increase in the index from year over year. Bottlenecks in supplies of materials continue to affect major industries, which coupled with shortages of skilled labour, has resulted in significant increases in the cost of constructing new developments. Although the easing of COVID health measures have removed the regulations imposed on construction sites, high construction costs and labour scarcities remain major challenges.

iii. The Local Office Market

As with all major cities, disruptions caused by the COVID-19 pandemic have had a significant impact on the Toronto office market. The broad adoption of work-from-home arrangements has reduced demand for office space, resulting in rising vacancy levels. In the downtown Toronto office market, the vacancy rate has been steadily increasing, reaching a high in Q3 2022 of 8.7 per cent since the start of the COVID-19 pandemic. This is in contrast to the situation immediately prior to the onset of COVID when the rate was at a historic low of 2.9 per cent. Other areas of the GTA, including Toronto East, have experienced similar office vacancy trends but from a higher pre-pandemic base.

Nominally, rental rates in the downtown Toronto office market appear to be somewhat stable relative to pre-pandemic levels. After declining for four consecutive quarters between Q1 2020 and Q1 2021, rental rates have begun increasing again, increasing 5 per cent between Q3 2021 and Q3 2022. Net rents in the downtown office market are still lower than those reported in Q4 of 2019, which was estimated at $38.33 per square foot. Taking into account inflation, especially as it affects construction costs, the Q3 2022 net rental rate of $38.22 per square foot is effectively lower than pre-pandemic levels.

While 2022 saw many workers returning to the office, record vacancies in the market continue to be a concern for both newly constructed buildings and existing office space. Initial work-from-home arrangements arising from the pandemic have evolved into a longer-term, systemic change in office working arrangements with the so-called “hybrid model” being the most prevalent. Under this model employees split their time between the office and home usually on the basis of two to three days in the office. While it is not yet clear, whether this pattern will persist in the long term, current indications are that it is leading to reduced demand across the GTA.

New office buildings are expected to incorporate new safety and design features such as flexible space options, improved indoor air quality, and touchless technology. As a result, demand for Class A office buildings that provide these features is expected to improve faster than for older lower buildings, many of which will require retrofitting.

A second factor, which may reduce the demand for space, is the growing possibility that a recession may occur in 2023. While recessions are part of the normal economic cycle and therefore pass in time, they do have the potential to depress demand for considerable periods.

While these shifts in office use and demand do not directly affect the eligibility of developments for the IMIT grant, the potential developing oversupply of office space and the resulting impact on the IMIT grant's ability to achieve its objectives should be considered.

In relation to the market outlook for the three subject buildings in the East Harbour project, there are no major office buildings sufficiently close enough to provide an indication of market demand. However, other areas at the periphery of the downtown core are somewhat comparable.

Even during the period of historically low office vacancy rates prior to the pandemic, competition for development sites from a very strong residential market was challenging the viability of office projects. Without direct access to Union Station and existing subway lines, it is more difficult to secure tenants even though office rents are typically lower in areas outside the downtown core. This would be especially true for East Harbour were it not for the fact that Metrolinx and the City are taking action to transform East Harbour into a major transit hub. A GO station is planned to be operational by 2027 and will provide a direct connection to Union Station and the existing Lakeshore East line. The station will also be connected to the future

Ontario Line, with subway service anticipated by 2030. The transit infrastructure is essential to the success of East Harbour. Construction is in the early stages and GO station is a number of years away from completion. The Ontario Line is a much larger and more complex undertaking and, if past experience is a guide, may be subject to completion delays. This in turn may delay construction and lease-up timelines for the East Harbour buildings.

3. Analysis of IMIT Applications

This section discusses the analyses of the IMIT applications in relation to the key considerations described in Section 2. The analyses involve a review of all relevant application details and financial information provided by the applicant. Interviews were conducted with the applicant to obtain information about the projects and to explain the approach to the analyses.

Of the three applications from Cadillac Fairview that were analysed, Building 1B is discussed in detail below while the other two (Building 1A and 2A) were judged to be premature.

A. East Harbour – Building 1B

Approximately 1.3 million square feet of AAA office and retail space is proposed within a 44-storey office building at 21 Don Valley Parkway. The site, which was previously occupied by the recently demolished Unilever Soap Factory, is vacant. Before it can be developed, a number of remediation issues will need to be addressed.

Cadillac Fairview submitted a Site Plan Application for Building 1B in April 2022.

i. IMIT Program CIP By-law Objectives

This development project supports a number of the CIP's objectives:

- Provision of space to accommodate an estimated 6,500 jobs;
- POPS enhancing the site's adjacent connection to the future East Harbour Transit Hub; and
- Improvement of the physical character of underutilized land.

ii. The “But For” Test

As it stands, given current market conditions, with or without an IMIT grant, the East Harbour project is unlikely to be built and occupied within the original timeframe. In this sense, the “But For” test does not have a significant enough impact on development viability to a degree that would influence project outcomes. This is in part due to the high levels of office market vacancies, and the uncertain timeline of the transit hub completion. However, as conditions improve, the project will meet the “But For” test by showing that the IMIT grant has the potential to advance the timing of the project by enabling lower gross rent to be charged while maintaining financial viability.

Financial tests were considered within the context of strong pressure for additional residential development in this location, the inflationary construction environment and uncertainties regarding demand in an area that has no history as an office location.

Because the viability of the project depends highly on the planned East Harbour transit station, the inherent uncertainty of the 2027 target completion date of the GO Line infrastructure is also a risk that must be considered.

iii. Land Use Planning Objectives

The proposed building is intended to bring a significant amount of new, high quality office space to the East Harbour area. The development will further the City’s planning objectives of protecting and promoting non-residential development and employment growth, as well as promoting the development of infill sites. It will be the potential catalyst for a major new cluster of employment and will support the investments being made in rail transit infrastructure.

iv. Community Infrastructure Benefits to the City

This project includes several investments in public infrastructure, subject to ongoing negotiations. These include:

- $10.5 million in public art;
- $1.0 million in public realm landscaping on top of the flood protection landform;
- Delivery of 1,400 m^2 of affordable incubator employment space;
- Delivery of 2,800 m^2 of cultural community space for a term of 25 years;
- $5.0 million contribution to offsite affordable rental housing; and
- $3.5 million contribution to community services and facilities serving the worker populations and adjacent neighbourhoods.

v. Other Fiscal Considerations

It is estimated that over its ten-year term the IMIT grant amounts for this project would be in the order of $76 million. At the same time, the City would receive approximately $100.9 million in net new property tax revenue over the same period. Thereafter, the development will continue to generate an estimated $25.2 million in annual City property tax revenues. It is important to note that these estimates represent 2022 dollars. The actual amounts of grants and tax revenues will depend on the assessed value of the building and the annual City tax rates.

vi. Market Context

As noted previously, there is no comparable major office development in proximity to East Harbour. At best, the area is somewhat comparable to buildings located west of the downtown core. Without direct access to Union Station and existing subway routes, rents would be lower compared to the downtown core, and securing tenants likely be more of a challenge, especially given increasing vacancy rates across the GTA. Nevertheless, assuming it is successful in the long term, this project will be a catalyst and will help establish East Harbour as a desirable new location for office employment uses.

vii. Conclusion

Given evolving office-work patterns, current trends in vacancy rates, high construction costs, timing risks of transit infrastructure, and the untried market for office space in the East Harbour location, it is evident that the level of risk for the Building 1B project is greater than is typical for projects of this scale in Toronto. On the other hand, the project's potential catalytic role in the establishment of an important new employment cluster would be beneficial to the City. For these reasons, it is our opinion that the East Harbour Building 1B project satisfies the objectives and requirements of the IMIT program. While currently the project may not satisfy the IMIT grant's "But For" test, we are of the opinion that should the grant be provided, it will improve the development viability and advance the timing of when the project will proceed.

It is, however, important to note that the current market environment for the East Harbour project is much different from when the project was first introduced. As it stands, the demand for office space has continued to decline since the onset of the COVID-19 pandemic. However, market conditions may well shift significantly by the targeted 2028 completion date as work arrangements continue to return to pre-pandemic patterns and as economic conditions improve.

Independently, the East Harbour project satisfies the criteria for a development eligible to receive a grant through the IMIT program. However, the City in reviewing future office developments for the IMIT grant will need to pay special attention to the changing nature of office space demand and the potential impact it may have on the grant's ability to bring office development projects to a position of market viability.

B. East Harbour – Buildings 1A & 2A

The proposed Buildings 1A and 2A are designed to contain 1.2 million and 1.3 million square feet of space respectively in 43 and 48 storey AAA office buildings. The site of the proposed buildings would require remediation work prior to the construction.

At present, there are uncertainties regarding details of the two buildings and importantly, their relationship with the form and timing of development on adjacent sections of the East Harbour development and to the transit infrastructure. A site plan application for 2A has yet to be submitted. For Building 1A, there is an open site plan application that was submitted by the previous owners of the site, but it does not reflect the plan for the building now being proposed. Approvals for residential uses are being sought in East Harbour; these uses would enhance the appeal of Buildings 1A and 2A but may take a significant time to be realized.

Most critically, the large size of the two buildings in addition to the 1.3 million square feet in Building 1B is likely to take the market perhaps a decade to absorb. In the interim, factors such as construction costs, office demand, rental rates, competing projects in addition to the completion of the transit projects; all of which could have fundamental influences on the two projects; cannot be predicted with any reasonable degree of certainty. Given this, in our opinion it would be imprudent to commit the City to providing IMIT grants at this time. This should not be viewed as precluding fresh applications being made in the future once there is a higher, more reasonable level of certainty regarding project details and timing.

4. Summary of Report Conclusions

The conclusions of this report are guided by the detailed qualitative and quantitative analyses. The key conclusion is that **the East Harbour Building 1B warrants receiving a grant under the IMIT Program**. The provision of the grant will support the development of substantial new employment space in the growth sector of Toronto's economy by helping to reduce financial risk, and particularly those risks associated with non-residential development in a post-pandemic market. The grant has the potential to help attract tenants in East Harbour, advance construction, and catalyze non-residential development in the area.

The IMIT grant applications for East Harbour Buildings 1A and 2A are considered premature due to uncertainties around the potential timing of planning application processes and construction. This should not be viewed as precluding fresh applications being made in the future once there is a higher, more reasonable level of certainty regarding project details and timing.