ECONOMIC VIEWPOINT

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017
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#1 BEST OVERALL FORECASTER - CANADA

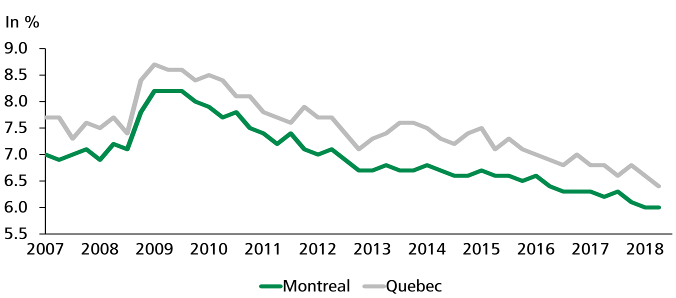
Industrial Real Estate Is Booming in Montreal and Quebec CMA's

Montreal's industrial real estate market, which stagnated for many years, is experiencing a genuine boom. Demand is strong and supply remains fairly limited due to the high cost and scarcity of land, which limit construction, particularly on the island of Montreal. Development requiring wide tracts of land is being done mostly on the outskirts, whereas older buildings in the more central neighbourhoods are ripe for revitalization, giving some sectors a fresh start in a new direction. The market in Quebec CMA is also doing very well, despite the lack of available land. The redeployment of certain areas and the development of a few sites have met some of the industrial sector's growing needs.

New Love for Industrial Buildings

Net rents in the Montreal metropolitan area, which were stable for many years at around $5 per square foot, are now edging closer to $6 per square foot, improving profitability for landlords. The buildings for sale are sparking the interest of local and foreign investors, increasing the frequency of multiple purchase offers. This has driven up prices for industrial buildings and pushed down capitalization rates for such transactions to about 6% (graph 1). This makes for fairly good returns, even if they are not as lofty as for other real estate assets (graph 2).

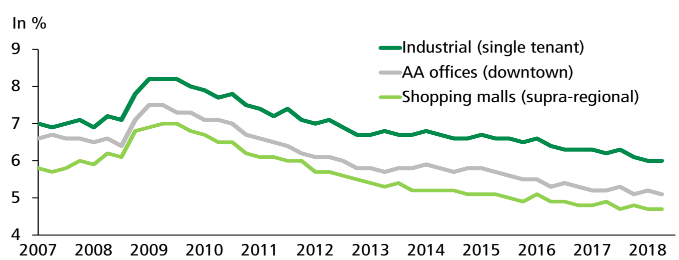
GRAPH 1
Trending overall capitalization rate (OCR) of single tenants in the industrial market



Source: Altus Group Investment Trends Survey, second quarter of 2018

At close to 5%, the vacancy rate for buildings in Greater Montreal has fallen to its lowest level in about 15 years. That said, the market is not as tight as in Toronto and Vancouver, where the percentage of unoccupied industrial buildings hovers at around 2%. The shortage of land is even more severe in both of those cities, which helps keep the vacancy rate very low. The advanced age of the buildings in Montreal, where about half of the buildings in the area were built before the 1980s, partly explains the higher vacancy rate. Insufficient ceiling heights in most of these buildings make them outdated and poorly suited to meet current needs in most industries. The vacancy rate for old buildings is about 9%, while more recent buildings, or those built from 2000 onward, have a vacancy rate of less than 4% according to Altus Group. Non-renovated buildings that are not suited to today's reality and lesser quality buildings have more trouble finding tenants, even if the rents are lower.

GRAPH 2
Overall capitalization rate (OCR) per benchmark assets class in the Montreal market



Source: Altus Group Investment Trends Survey, second quarter of 2018

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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

New Life for Old Buildings

Newer builds with ceiling heights of over 24 feet are still the most popular. However, demand for older buildings that had trouble finding takers is starting to grow, spurred by emerging new industries like computing centres for cryptocurrencies and commercial cannabis cultivation, to get ready for its upcoming legalization. Older facilities are quite suitable for these types of businesses, where the location criteria are more flexible than in the broader industrial market. These energy-intensive industries tend to seek out facilities that are located close to a good source of electricity.

Outdated industrial facilities and the lack of large adjacent spaces also argue in favour of redeveloping or converting buildings, with some districts being entirely re-purposed. In Mile End/Mile Ex, for example, a large number of aging industrial buildings have been converted into rental lofts to meet the needs of the new economy. This area is becoming a modern, hip place to be, with new industries like video gaming, multimedia and life sciences and more recently artificial intelligence firms breathing new life into older properties. This area has gone through a genuine transformation since several textile plants closed 10 years ago, with most spaces being revamped from top to bottom.

More New Builds

A dearth of industrial products on the market has jump-started a rash of new projects since the start of 2018. Custom construction projects are popular, as they are built based on the new tenant's specific criteria. Large-scale buildings are mostly being built on the periphery of the island of Montreal. They include the new major distribution centres for Costco and Jean Coutu in Varennes, for Sobeys in Terrebonne, for IKEA in Beauharnois and for Canadian Tire in Coteau-du-Lac. The availability and cheaper cost of land (table 1) and quick access to highways bode well for development on the outskirts of Montreal.

TABLE 1
Land in central areas nets higher prices

SECTOR	LAND VALUES ($/SQ.FT)
Montreal East	6 to 10
West Island	12 to 20
Saint-Laurent	15 to 20
Laval	6 to 10
North Shore	2 to 5
South Shore	3 to 8

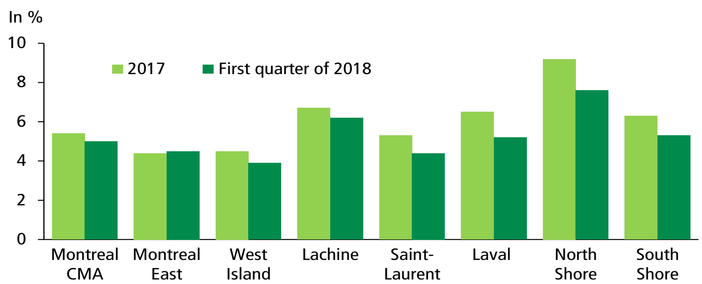
Sources: Altus Group and Desjardins, Economic Studies

Greater Montreal is not home to much speculative development, since the industries that opt for new builds often have specific needs that are best suited for custom construction. High land prices and the sometimes substantial cost of demolition or decontamination mean that developers must tread carefully. That said, strong demand for industrial spaces and climbing rents are driving some developers to erect new buildings without knowing who their new tenants will be. The risk is not as high when industry demand is strong, however, given the solid outlooks for sales or rentals. The uncertainty that a building may not provide the type of space a potential tenant is looking for means that speculative development remains more vulnerable nevertheless.

The Pulse of Montreal's Submarkets

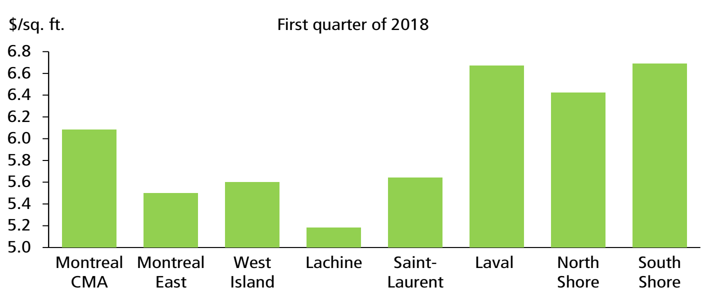
Each of the different sectors in the Greater Montreal area has its own dynamic, based on the industries in that area, the characteristics of its existing buildings and the availability of land for development. The industrial vacancy rate in the East end of Montreal has stabilized at around 4.5% since last year (graph 3). While rents are rising, they are still among the lowest in Greater Montreal (graph 4). Construction is low, but a number of development projects could take shape with the rehabilitation of several large tracts of land well located of the Shell refinery.

GRAPH 3
Vacancy rate in Montreal's industrial market



CMA: Census Metropolitan Area
Sources: Jones Lang LaSalle IP, Inc. and Desjardins, Economic Studies

GRAPH 4
Average net rents in Montreal's industrial market



CMA: Census Metropolitan Area
Sources: Jones Lang LaSalle IP, Inc. and Desjardins, Economic Studies

The distribution sector is in full swing on Montreal's West Island, supporting rental activity for this type of use. The vacancy rate for industrial premises—at 8% three years ago—is now below 4%, the lowest in the main areas of the Greater Montreal region. Net rents continue to climb, pushing up profitability for building owners. According to Jones Lang LaSalle,[1] most industrial land is owned by developers on the lookout for speculative or custom construction projects. The vacancy rate in Lachine is falling, which puts upside pressure on rents. There is little undeveloped land in this area, however, and the development potential is limited. A project to demolish an obsolete building will pave the way for new facilities to be built on the site.

Unlike the Island of Montreal, where the supply of buildings is limited, submarkets like Laval and the North Shore have more industrial premises available and more land to develop. The vacancy rate in Laval continues to fall, and rents are climbing, despite the number of new industrial buildings that opened their doors in 2017. According to Jones Lang LaSalle, the new tax incentive put in place at the end of 2017 should give new projects a boost.

The North Shore faces stiff competition from Laval market, which has experienced rapid growth. Despite the improvement in recent years, the vacancy rate on the North Shore is still relatively high at about 7.5%. The availability of several tracts of land and their relatively low price offer various construction opportunities. Strong demand on the South Shore continues to push up rents, making speculative construction more attractive.

Different Dynamic in Quebec CMA

The industrial market in the metropolitan region is active, but the scarcity of land in the central areas limits development. A number of technology companies are opting for custom construction to meet their highly specific needs for growth. New buildings are freeing up space in the multi-unit sector. Some companies become tenants in these new buildings, while others prefer to be their own landlords.

According to CB Richard Ellis, almost 50% of Quebec City's industrial spaces are owner-occupied. The other half is rental space with an availability rate of about 2%. Industrial premises are thus are hard to find in this market, meaning that tenants who need more space at their existing location or even those who are willing to move elsewhere have few options. The limited supply of industrial buildings is driving up net rents, which range from $7.50 to $9.50 per square foot, higher than in the Greater Montreal area and the Canadian average.

The re-purposing of certain spaces is also supporting activity in the greater Quebec City region. A few projects to demolish old buildings and redevelop existing clusters are designed to increase residential density. Industrial sites still being developed include the Innoparc in Lévis, with large spaces located along Highway 20, and the Espace d'innovation Chauveau on the North Shore, soon to be the new distribution centre for retailer Simons. An available piece of land in the Espace d'innovation d'Estimauville found a taker for a medical company that will be moving in to a new building. Despite the shortage in the central areas, several parcels of land on the outskirts are available, including in the industrial parks located in Saint-Augustin-de-Desmaures and Val-Bélair.

Issues and Outlooks

In spite of the many positive developments taking place in the industrial real estate market, a number of issues are shaping the industry right now. The scarcity of land in Montreal and Quebec City is a boon for redevelopment projects, often a long and expensive process, especially when re-purposing or demolishing existing buildings or when land decontamination is required. Industrial spaces can sometimes disappear to make way for projects to improve residential density and help create new neighbourhoods. This revives outdated sites, giving them a second life that is more in step with today's realities. Real estate development helps us look to the future, but projects must be well positioned and rally a number of partners toward a common goal. Nevertheless, regulatory requirements, high property taxes and substantial development costs all represent obstacles the industry has to overcome.

The restructuring of industrial spaces, through a revitalization project or new construction, often ushers in a new business culture, which then draws the workforce closer. A new building or an updated work environment usually makes it easier to hire and retain workers. In a context where there are too few workers to fill positions in some companies, having quality workspaces in buildings that offer on-site services is becoming a factor in attracting the best talent.

Adapting to the new public transit projects is one issue the real estate market will have to face in the future. In Montreal, the future Réseau électrique métropolitain (REM), the possible extension to the metro's blue line and the potential addition of the pink line will enable the real estate sector to develop these available spaces. The REM will jump-start development of the land adjacent to the metro stations, especially as TOD (Transit-Oriented Development)—offices, retail space and housing—to ease the integration with new transportation infrastructures. How the industrial market articulates its development around these clusters remains to be seen.

Although the industrial market is going through a boom in terms of sales, rentals and construction, it is not immune to an abrupt change in the economic backdrop. Heightened trade tensions between the United States and several of its partners, including Canada, China, Europe and Mexico, as well as the current and

[1] *Industrial Insight Report - Greater Montreal Area*, Q1 2018, Jones Lang LaSalle IP, Inc. 9 p.

future escalation of tariff barriers, threaten to compromise the expansion cycle. While some industries are already feeling the impact of import and other border tariffs, the industrial real estate market has thus far been spared from any widespread impact. The risks of deterioration are very real, however, even if the situation looks good right now.

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