ECONOMIC VIEWPOINT

Quebec's Non-residential Real Estate Market: The Extent of the COVID-19 Jolt

While the non-residential real estate market has been on a roll in recent years, driven mostly by the strength of Quebec's economy and the resurgence of Montreal, the shock caused by COVID-19 has upended the situation. The conditions in different markets have evolved differently. Shopping centres were deeply affected, and this happened in a flash. Office buildings began to feel the impact of telework on a broad scale. In the industrial sector, however, occupancy remained high and rents increased. The exceptional performance in recent years has mitigated the effects of the pandemic across all market segments. Some are doing better than others and investors are positioning themselves accordingly. That said, the non-residential real estate market in Montreal and Quebec continues to compare well with other Canadian CMAs.

Office Buildings: The Adjustment Period Is Just Beginning

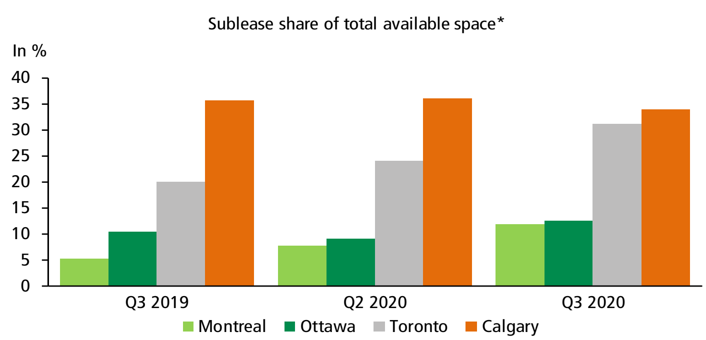
The impact of the pandemic on the office market has been fairly limited up to now. While many employees found themselves working from home overnight since mid-March, the impact on space rentals was not felt immediately. Most of the leases signed are for several years: large tenants usually sign for a ten-year period, while smaller tenants generally commit to three to five years. Companies that have this type of medium- and long-term commitment are currently considering how much space they will need over the years to come. However, the decision will have to be made by the lease's date of renewal.

Most companies with lease commitments are currently in "space maintenance" mode instead of "growth" mode while they assess their future needs. Tenants in prime locations will not make hasty decisions. Many tenants whose leases are expiring will even prefer to renew in the short term rather than relinquish their space. Keep in mind that prior to COVID-19, buildings with large areas available for rent were scarce. Work location proved to be one of the factors that attracted and retained employees. As such, companies want to be well positioned once this health crisis is behind us.

However, subleases make up part of the market for office buildings. COVID-19 had a much faster impact on this type of occupancy, which is often linked to short-term commitments. Some companies have vacated space while others have opted to relocate to the outskirts of the Island of Montreal, spurred by lower rents, proximity to employees' homes and larger spaces that make social distancing easier. For example, the height of buildings, which is significantly lower than in the downtown area, facilitates elevator traffic. The attractiveness of the suburbs could also translate into a reduction in surface area sublet downtown.

The adverse effects of working from home are increasingly being felt in sublet spaces across the country. In the third quarter of 2020, available space for subleases increased in most major markets in Canada, but remained relatively low in downtown Montreal (graph 1). The relocation of some tenants to the suburbs propped up the overall demand for sublet space,

GRAPH 1
Office buildings: sublease space increased in many Canadian markets



* Class A downtown buildings.
Source: Altus Group

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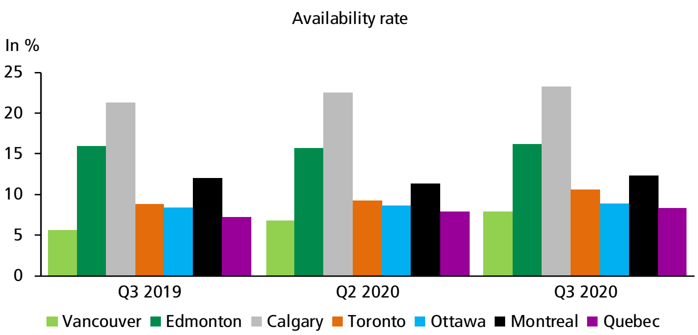
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

but Montreal's downtown core was hard hit. In the next few quarters, the traditional rental market will be dealing with the expired leases of some long-term tenants, which will also increase the available space. This means we can expect a rise in the availability rate in Greater Montreal. Availability rate is the percentage of available rental space relative to inventory.

In Quebec CMA, the office availability rate was 8.3% in the third quarter of 2020, one of the lowest in the country. Unlike the Montreal market, where half of the inventory is located downtown, the Quebec CMA is spread across different hubs. As a result, the Quebec market is less vulnerable to a massive displacement of clients from a particular area. The provincial government occupies about 25% of the space in the Capitale-Nationale, mainly in the area of Parliament Hill. Canada-wide, Vancouver, Toronto and Ottawa show lower availability rates than Montreal (graph 2). The difficulties in the oil industry continue to weigh on the market in Alberta's two major CMAs.

GRAPH 2
Office buildings in Canada's major markets: Quebec and Montreal holding up well so far



Source: Altus Group

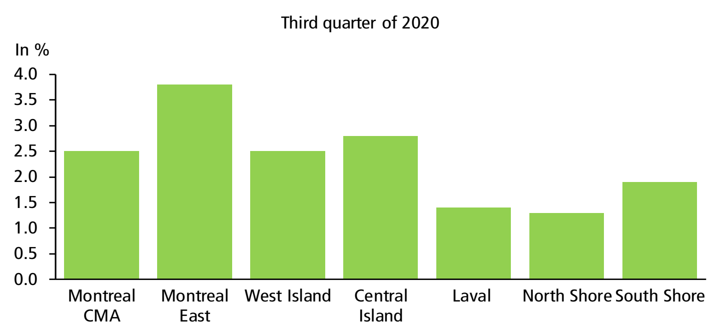
Rents in Montreal continued to rise in the third quarter, but at a more moderate pace than before. Expect some initial stability possibly followed by lower rents in the next few quarters. It usually takes 18 to 24 months to feel the full impact of a changing landscape in the office building market. The most recent availability rate and rent statistics don't reflect all the consequences of this current health crisis. According to an Altus Group survey, rents of office buildings in Quebec CMA will not increase within a year.

Resilience of the Industrial Sector

To date, the industrial real estate market has not been too deeply impacted by the pandemic. The demand for large spaces has in fact grown since last spring. According to CBRE Research, several industries supported this demand: wholesale, food and beverage, distribution and warehousing, and most of all, e-commerce players. Thanks to the accelerated digital shift in several companies, this booming sector provides a short-term buffer for the industrial market. Large premises remain scarce, but modest-size spaces are being freed up by smaller companies that are struggling. In many cases, freed-up spaces allow landlords to bring in new tenants at a higher rent than the previous tenants.

Since the onset of COVID-19, the industrial market has stood out from other non-residential real estate segments due to the flexibility of rent collection, lease terms, financial incentives and even free rent in some cases. In addition, according to an Altus Group survey, rent collection rates exceeded 80% in the industrial sector for the second quarter of 2020. According to CBRE Research, this market is still very tight, with an overall availability rate in Greater Montreal of 2.5 % in the third quarter (graph 3). The North Shore and Laval submarkets are even tighter, with demand for space increasing. In Quebec CMA, the industrial space availability rate is around 2%, which continues to put upward pressure on rents.

GRAPH 3
Montreal's industrial market availability rate



CMA: Census Metropolitan Area
Source: CBRE Research

However, this very positive assessment for Montreal and Quebec CMAs is partly due to two government programs, namely the wage subsidy for businesses and the commercial rent assistance program (box on page 3). Both of these financial support measures have enabled many businesses to stay afloat while preventing their financial situation from deteriorating too much. The end of government support to early could have created challenges for several businesses that could have reduced the amount of space they occupy or even completely free up space if they move to less expensive premises or shut their doors for good.

The industrial market, although currently very tight, will be vulnerable by the end of the financial compensation, which will affect the companies that have benefited from these support measures. Some will be harder hit than others depending on the recovery's progress in different areas of activity and the outlooks in the context of the pandemic. Despite the short-term possible deterioration, the strong footing of the industrial market

BOX

Government support measures

The federal government extends the Canada Emergency Wage Subsidy (CEWS) until summer 2021. This program covers up to 75% of employee wages to a maximum of $847 per week for eligible businesses and non-profit organizations. This measure has helped keep many workers on the job despite the financial hardship of their employers due to COVID-19. Layoffs will likely be necessary in companies that don't get back to a sufficient level of activity by the end of the program. For some, the company's very survival may even be at stake. The extent to which this will translate into a drop in industrial rental space remains to be seen. The end of this program will also affect the office building and shopping centre markets. Barring another extension of the federal program next summer, the companies that continue to benefit from the program will face their moment of truth, whose survival will still depend on this financial assistance.

In addition, the "Canada Emergency Commercial Rent Assistance (CECRA) provided relief for small businesses experiencing financial hardship due to COVID-19." CECRA covered 50 per cent of the rent, with the tenant paying up to 25 per cent and the property owner forgiving at least 25 per cent. Over the course of the program "Canada's COVID-19 Economic Response Plan", property owners reduced rent by at least 75 per cent for the months of April to September, for their small business tenants. This measure, which ended, has been replaced by "the Canada Emergency Rent Subsidy (CERS), which will provide rent and mortgage financial assistance until June 2021. CERS will be able to cover up to 65% of eligible expenses, and up to 90% for businesses that have had to close because of an order from local authorities." The industrial, retail and office building sectors should all be supported by this program under the eligibility requirements.

in Montreal and Quebec CMAs should help absorb the impacts without too much damage (graph 4).

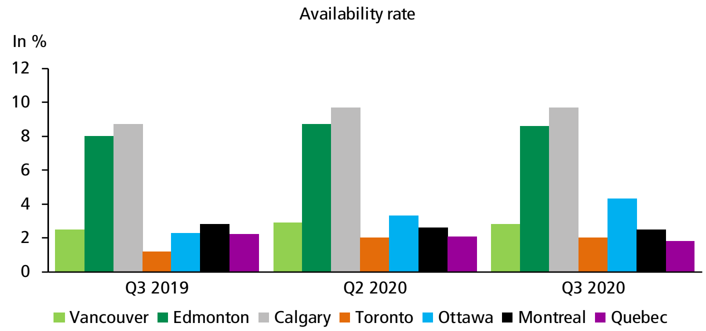
Shopping Centres Pummelled

To date, shopping centres have suffered the most from the pandemic's repercussions. The impact was immediate during the lockdown and the after-effects are still being felt following the reopening of businesses. Traffic remains low in several malls and many retailers are still struggling to pay their rent. According to an Altus Group survey, the rate of rent collection by landlords in the second quarter was less than 40% in the retail sector, compared to 80% in the industrial sector.

The situation has deteriorated significantly in large shopping centres, while neighbourhood centres with grocery stores, often in the suburbs, are doing better. The situation remains difficult in the apparel and footwear sector, with several banners already

GRAPH 4

Industrial market availability rate: Quebec and Montreal compare well on a Canada-wide scale



Source: CBRE Research

requesting *Bankruptcy and Insolvency Act* protection. The major centres will face a drop in occupancy and rents. Lower quality malls, which haven't been renovated in recent years, will be impacted the most.

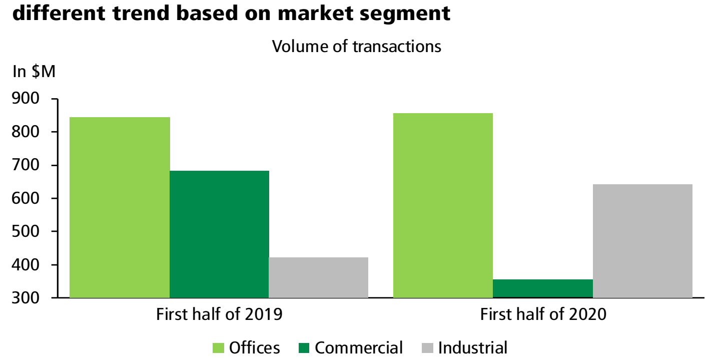
Prospects for Investors

At the beginning of the pandemic, transactions to purchase and sell properties across all categories were put on hold as owners focused on securing their buildings from a health standpoint. There were no panic-induced fire sales, but many investors were looking for opportunities. There is an abundance of liquidity on the market right now, especially for institutional investors, which helps to weather this period of uncertainty. They are on the lookout for trading opportunities during this prolonged period of low interest rates, which will help limit downward pressure on property values.

The commercial shopping centre category is the most worrisome, as rents are expected to fall in this market segment and the vacancy rate is likely to rise over the coming quarters. The impact of COVID-19 on this asset class was immediate (graph 5 and graph 6 on page 4). More sellers than potential buyers

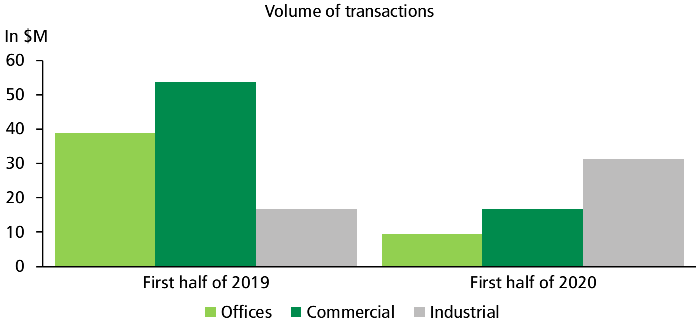
GRAPH 5

Investments in non-residential real estate in Montreal CMA: different trend based on market segment



CMA: Census Metropolitan Area
Source: Altus Group

GRAPH 6
Investments in non-residential real estate in Quebec City*: diverging trend based on market segment



* Excluding Lévis.
Source: Altus Group

are turning their backs on this product. As such, the outlook is negative for the value of shopping centres and rental income.

Investors will continue to favour industrial properties despite the possible deterioration of this market. Even if vacancies increase, their current low level coupled with the increase in rents in recent years will ensure acceptable incomes for landlords. Given the number of owner-occupied buildings, the secondary industrial rental market is quite limited, which should help it to weather the storm.

It usually takes 18 to 24 months for the office building segment to react to economic cycles. Six months into the pandemic, the situation is already starting to deteriorate, a trend that should continue for a few more quarters. After that, everything will depend on when a vaccine or an effective treatment become widely available. Only then will it be possible for most employees to return to the workplace, although working from home should have increased. How the long-term consequences of this structural change will affect demand for office space remains to be seen. In the meantime, the industry is dreading the potential effects of the second wave of COVID-19 cases. Uncertainty still weighs heavily in the air. Buildings already under construction will be completed, but there will be fewer future development projects for some time.

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