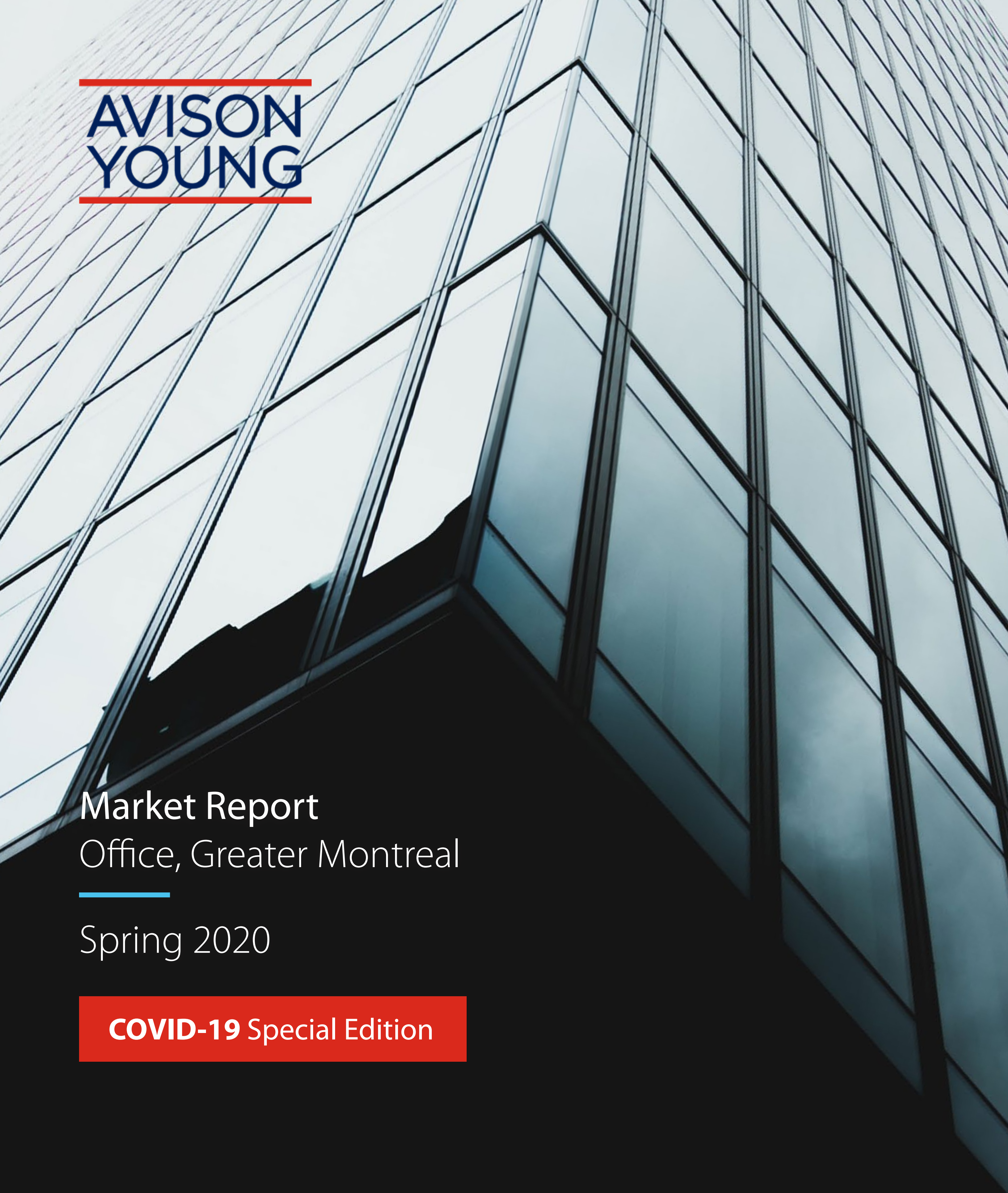

Market Report
Office, Greater Montreal

Spring 2020

COVID-19 Special Edition

Photo: William Bayreuther, Unsplash

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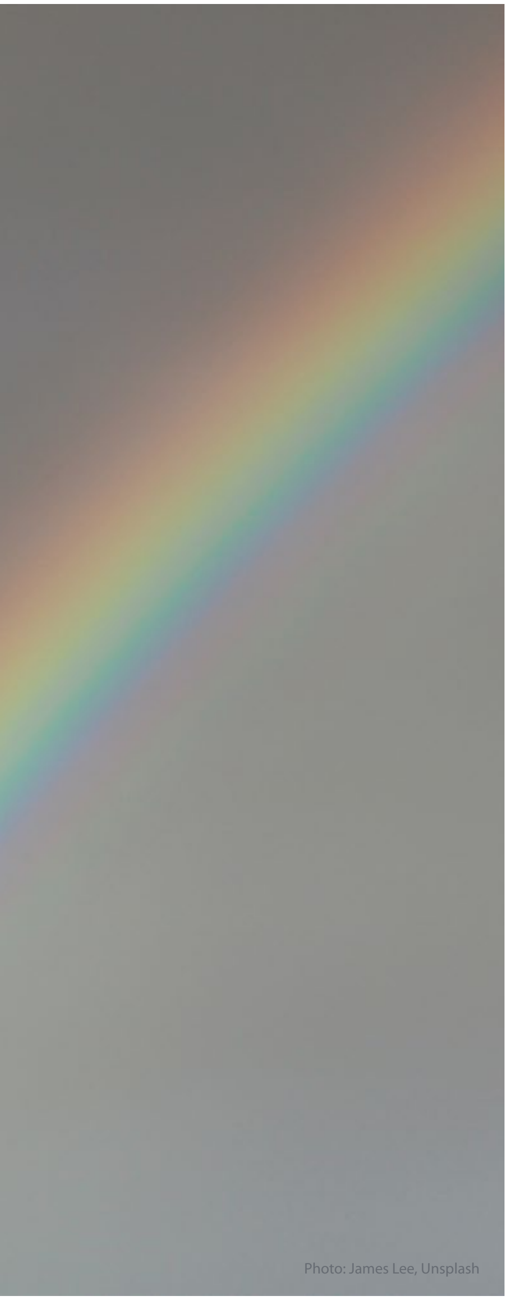

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AVISON YOUNG

Everything was fine, until now.

The Montreal office market continued to show signs of recovery over the past quarter, with declining availability rates, stable occupancy costs, good construction activity and several new projects underway. Then the COVID-19 pandemic happened. We are now on the brink of a global recession.

The unprecedented nature of the crisis makes it extremely difficult to predict the severity, duration and impact of the slowdown on the office market. It is also difficult to predict the trajectory of the recovery that will follow, which is problematic at this early stage.

Office leasing: before the crisis

The beginning of 2020 was promising: at the end of the first quarter, the office availability rate in the Greater Montreal Area (GMA) continued to fall, reaching 10.9%, while it stood at 13.2 % barely 12 months ago. In Downtown Montreal, it dropped from 11.5% to 8.8% over the same period, reaching 8.5% for Class-A buildings.

The Laval submarket recorded a spectacular decrease in availability, dropping from 15.1% to 8.5% in just a year. This decrease is partially due to the construction of the Réseau express métropolitain (REM), which has prompted several companies to open satellite offices further north in order to provide a workspace for the many employees who are affected by the construction and the closure of the Mont-Royal tunnel, as well as the relocation of employees of the city of Laval following the temporary closure of the town hall until 2024.

On the South Shore of Montreal, availability also dropped, falling from 15.5% to 11.5% over the past year. This decrease is also attributable to the REM construction, as Brossard's future connectivity to the rest of the public transit network attracts several companies in the sector, benefiting Quartier DIX30, as well as complexes Jonxion and Solar Uniquartier. The latter has recorded a steady transaction volume over the last quarters as 3400 De l'Éclipse Street now shows an occupancy rate hovering around 90%.

Occupancy costs have not fluctuated a lot in recent quarters. Gross rents in Greater Montreal and downtown Montreal remained relatively stable between the first quarter of 2019 and the first quarter of 2020, orbiting respectively around $28.50 per square foot (psf) and $34.50 psf.

Image: Phil Desforges, Unsplash

Construction

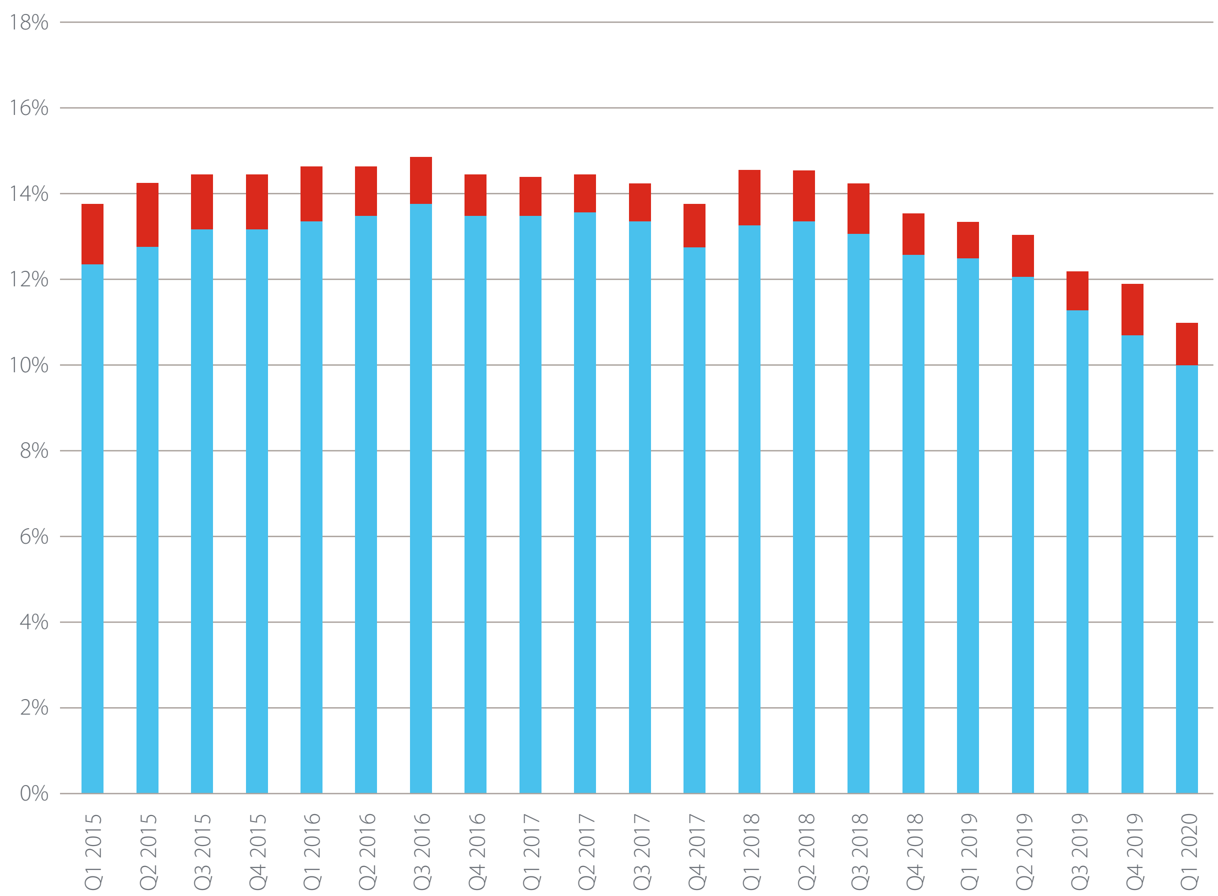
At the end of March 2020, 20 buildings were under construction in the GMA, totaling more than 3.8 million square feet (msf).

Of these 20 buildings, four are located Downtown Montreal, totaling more than 1.5 msf. These buildings include megaprojects Victoria sur le Parc and the new National Bank headquarters, respectively located at 700 and 800 Saint-Jacques in the central business district.

Because of the pause caused by the measures put in place by the government to prevent the spread of COVID-19, delays in delivery are to be expected for buildings currently under construction, all of which are put on hold for an indefinite period.

However, given the resuming of residential construction activity, we can expect that construction sites will gradually resume in the coming months, resulting in the progressive reopening of the construction industry supply chain, starting with the residential sector, and the consequent reopening of many SMBs.

Availability Rate | **Greater Montreal** | Past 5 Years



Source : Altus Group Limited

Photo: Phil Desforges, Unsplash

Office leasing & **COVID-19**

Across most sectors and markets, leasing activity will decline in volume compared with pre-crisis expectations.

While some transactions will be unaffected, many deals currently under consideration are likely to be delayed (though not yet cancelled) as occupiers adopt a "wait-and-see" attitude. This disruption should prove temporary and we would expect a bounce-back in deferred activity during late 2020 and into early 2021.

However, a heightened sense of uncertainty over the economic and business outlook will cause some deals to be withdrawn. Fewer new transactions will be initiated, and some expansion plans will be put on hold.

Clearly the extent of this slowdown will be highly variable across markets and will depend on how the economic impacts of the disease play out.

Laurent Benarrous
Principal, Avison Young

Chartered Real Estate Broker
Avison Young Québec Inc., Commercial Real Estate Agency

According to Laurent Benarrous, Principal at Avison Young's Montreal office, the current phenomenon is comparable the formation of a tsunami.

"The first phase starts with a strong earthquake, which is the pandemic in the present case. In the second phase, water movements begin to surface for a certain period. We are currently in this phase: companies have felt the shock and they are calling on us to seek advice and identify the best solutions for their real estate decisions. Some of them are seeking to negotiate rent relief, others are temporarily suspending expansion projects while some are already taking steps to reduce their occupied space. We advise our clients to act with caution without giving in to panic: an earthquake does not necessarily produce a tsunami: it all depends on the way in which the underwater topography reacts and transmits the deformation to the water column above. That's kind of what's happening right now."

What remains to be seen is how the third phase will unfold: will the coasts be hit by gigantic waves? "In such a case," explains Benarrous, "the waves will grow and could have particularly harmful impacts for landlords. If, on the contrary, the waves just miss the shores, they will gradually lose intensity and the quake will have caused more fear than harm. Despite the fact that we are currently in the second phase of the phenomenon, we advise our tenant clients to set up a post-COVID-19 monitoring plan. No matter how the waves hit, companies must be ready to make two observations in a timely manner. First, they should survey customers in order to determine if their clientele felt a decrease in service as their deliverables were worked on outside of the office space; second, they should survey their employees and evaluate their interest in telecommuting."

It is relatively safe to assume that as a result of these surveys, many companies will come to the conclusion that their space requirements should be reduced. "10% less, 30% less? When we have a clear indication of these figures, landlords will know if the waves hit them head on or if they just brushed against the shores."

Laurent adds: "Office space is largely occupied by service companies; however, after payroll, occupancy costs are the second most important expense for businesses. During the present crisis, layoffs are carried out very quickly. The same cannot be said for rental obligations for office space. Rent is the expense that most hurts service companies in the present situation, and the one that they will likely seek to reduce in the coming months."

Photo: Gabriel Beaudry, Unsplash

In the longer term, the changes that businesses and employees will implement during the crisis will only accelerate some trends already observable in the market, such as flexible working practices in the service sector. In the office sector only, telecommuting has already increased significantly. The business services sector, which accounts for 12 to 14% of the Canadian economy, is expected to embark on an unprecedented experimental shift focused on flexible work strategies at a global scale.

The impact of these new trends on productivity and deliverables has yet to be determined, but it will certainly accelerate the implementation of new technologies and flexible work practices. In the short term, social distancing could serve as a crisis simulation for many collaborative and flexible office space operators, since workers who have opted for short-term contracts will choose to work from home for weeks, or even months during the pandemic.

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Montreal
Office snapshot

Occupancy Costs

Average gross rents have not fluctuated much in the Greater Montréal reaching $28.53 psf in the spring of 2020 from $28.79 psf last March. In Downtown Montreal, average gross rental rates slightly dropped from $35.22 psf to $34.37 psf year-over-year.

Absorption

The Greater Montréal office market once again recorded a significant positive absorption over the past year, all asset classes included, as it reached 2,8 msf at the end of the first quarter of 2020. The quarterly absorption nearly reached 700,000 sf at the end of March.

Under Construction

3,8 msf of office space are currently under construction across Greater Montréal, **a little over 1.5 msf of which are located Downtown.**

Availability

The overall availability rate of Greater Montréal's office space has continued to decline, reaching 10.9% at the end of the first quarter of 2020. In Downtown Montréal, the availability rate is still the lowest it has been in recent years.

Photo: Guillaume Bolduc, Unsplash

Investments: before the crisis

From an investment standpoint, the Greater Montreal Area recorded a dazzling start to 2020 after 2019's record in office sales. Over the first quarter, several prestigious addresses have changed hands as investments in office buildings reached impressive levels. In fact, office sales for the first quarter totaled $632,835,000, which represents more than a third of the total office sales in 2019, which reached $1.8 billion.

Allied Properties REIT continued investing in Montreal in early 2019, with the acquisition of 747 Square Victoria in the central business district, for the sum of $ 276,000,000 (which represents approximately $491 psf). Also known as the Montreal World Trade Center, the building formerly owned by Ivanhoé Cambridge includes 562,589 square feet of leasable office space across two, 10-storey buildings, as well as a few ground floor retail units along Ruelle des Fortifications, which joins both towers. The new owners could add up to 60,000 square feet of office space to the complex, namely by reorganizing the common areas. With this investment, Allied Properties REIT continues the strategic positioning of its Montreal portfolio at the Downtown and Old Montreal junction.

A little further west in Downtown Montreal, Groupe Petra, in association with Groupe Mach, solidified its position as one of the most important commercial real estate owners in Montreal with the acquisition of 1100 René-Levesque Boulevard West for $225,000,000, which represents approximately $359 psf. Oxford Properties Group continues the disposition of its Montreal assets with the sale of the 27-storey, LEED and BOMA Platinum-certified building totaling 627,323,sf of office space. With this transaction, Oxford's only remaining office asset in the GMA is the Quartier DIX30 office portfolio in Brossard.

While most transactions were concentrated in the Downtown area in the first quarter, the Galion concluded the acquisition of 1611 Crémazie Boulevard East in Midtown North, previously owned by Industrial Alliance. Galion purchased the 10-storey building totaling 213,298 square feet for $41,000,000, which represents approximately $192 psf. In addition to its Class-A building status and BOMA-Gold certification, the building benefits from its prime location alongside metropolitan highway, facilitating access for tenants from all over the GMA.

Robert Metcalfe, C.App.
Principal, Capital Markets, Avison Young

Chartered Real Estate Broker, Broker of Record
Avison Young Québec Inc., Commercial Real Estate Agency

Office investments & **COVID-19**

The coming months will certainly be more difficult in terms of investments of all kinds, and the office market will not be spared. Some investment transactions will be delayed or jeopardized due to practical constraints on completion (such as travel restrictions impacting on-site due diligence) or concerns over the outlook for the economy and occupier demand. Transaction volumes are likely to fall, probably quite sharply; while Q1 totals may be less affected, Q2 will be impacted by delays in completion and Q3 will be hit because few new transactions are currently being initiated.

According to Robert Metcalfe, Principal at Avison Young's Montreal office specializing in Capital Markets, the general confinement measures imposed by the government and the almost complete halt on certain services deemed non-essential during the COVID-19 crisis may hinder simple tasks such as accessing a building for inspection or appraisal purposes. "Other delays are caused by the obtaining of certificates from tenants ("estoppels") seeing as several businesses are temporarily closed and unusually long delays are now becoming the "new normal" for securing mortgage loans, with the increased volume of requests of all kinds made to lenders who are getting overwhelmed by the current situation", continues Metcalfe.

Another obstacle to lenders' decision-making processes during this pandemic period is the underwriting and assessment of the market value of commercial buildings, as the past assessments are no longer a reference for the future values in this period of great economic uncertainty. "In this unusual context," explains Robert, "the analysis criteria no longer rely on capitalization rates and other performance indicators, but rather on a more detailed analysis of the quality of tenants in place and their resilience to the pandemic and the severe economic recession that is expected in the near term. As a result, estimates of revenue growth become less important than quality and sustainability over time. Similarly, in the case of a commercial loan, the debt coverage ratio becomes the main standard that is considered at the expense of the loan/value ratio or any other analytical factor."

Photo: Bobby Tal, Unsplash

It is difficult to assess the likely scale of impact on real estate transactions, but a fall in transactions of 25%-50% for one or two quarters in those markets most severely affected cannot be ruled out, which does not spare the Montreal market.

As in the wider economy, any "wait-and-see" hesitation in completing existing transactions or initiating new ones will be partially offset by a "bounce back" effect once uncertainty is alleviated. It should be noted that demand for real estate investments generally remains at a high level with multiple sources of capital active in the market. Any reduction in interest rates and bond yields will also encourage further flows of capital into the real estate sector. We would therefore expect a significant increase in activity towards the end of 2020 and into 2021.

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