Office market report / 2020 review and 2021 forecast

Montréal, QC

Highlights

$34.22

average gross rental rate per square foot Downtown Montréal

13.8%

total availability rate all asset classes Greater Montréal

2.0%

sublet availibility rate all asset classes Greater Montréal

-1.2

million square feet annual absorption Downtown Montréal

As office workers have been working from home for almost a year, the emergence of flexible work solutions has opened up a debate about the nature of what everyone is now calling the *new normal*, and whether the changes incurred by the pandemic are cyclical or structural. Meanwhile, in spite of admirable efforts from landlords, property managers and employers to provide safe workplaces, the return to the office has been slower than expected, hampered by the second wave of the pandemic and the more severe containment measures that were put in place in Québec at the end of 2020.

Following the reopening of offices at a 25% capacity in July 2020, a small percentage of workers had returned to the office, hindered by employee concerns about health and well-being, mainly regarding public transit and difficulties relating to construction in Downtown Montréal, where construction activity makes moving around and social distancing challenging. Since the implementation of more severe containment measures at the end of 2020, office towers sit empty once again, as the government made working from home mandatory for office workers, with the exception of employees whose presence is deemed necessary in the workplace.

Luckily, most of Canada's office markets have entered the pandemic with strong fundamentals, low availability rates, and even lower vacancy rates, some markets showing particularly tight vacancy such as Vancouver and Toronto. In the Greater Montreal Area (GMA), the vacancy rate had steadily been declining over the past years, reaching 9.6% at the end of 2019, as 9.9 million square feet (msf) were vacant. From the available space perspective, the situation was similar: after hovering between 13% and 14% for several quarters in a row, the availability rate drastically dropped at the beginning of 2020 to reach its lowest value of the past seven years .

We did not know it at the time, but these healthy market conditions would counteract the first impacts of the pandemic, at least to some extent.

Under Construction

3.83

million square feet
under construction
Greater Montréal
16 buildings

3.07

million square feet
under construction
Class A
Greater Montréal
8 buildings

1.47

million square feet
under construction
Downtown Montréal
3 buildings

As companies revised their occupancy strategies over the course of 2020, availability increased exponentially in most Canadian markets. While many large businesses are still weighing their options relating to their office occupancy, the quickest reactions came from small and medium-sized businesses, as they started putting space back on the market during the third and fourth quarters of 2020. However, we are expecting larger firms to announce their decisions in 2021: while some could choose the *status quo*, others are expected to drastically review their occupation strategy, while further increasing the square footage available in the market and deepening the major impact of the pandemic.

In the GMA, the total availability rate (all asset classes combined) increased from 11.5% at the fourth quarter of 2019 to 13.8% a year later, which represents a total available area of 14.5 msf. Availability had dropped to 10.8% at the end of the first quarter of 2020, which represents its lowest point since 2013. The impact of the pandemic and associated lockdowns gradually manifesting itself over the year, the total availability has increased by almost 28% between the end of March and the end of December 2020.

In terms of space available for sublease in Montréal, availability rose from 1.2% of the office inventory in the fourth quarter of 2019 to 2.0% at the end of 2020, which represents a total area of over 2 msf. Again, the sublet availability rate fell early in the year, hovering between 0.9% and 1.0% between the first and second quarters. Since the end of June 2020 alone, the GMA's sublet availability has exploded from 959,601 square feet (sf) to 2,069,417 sf at the end of December 2020, which represents a staggering increase of 115%.

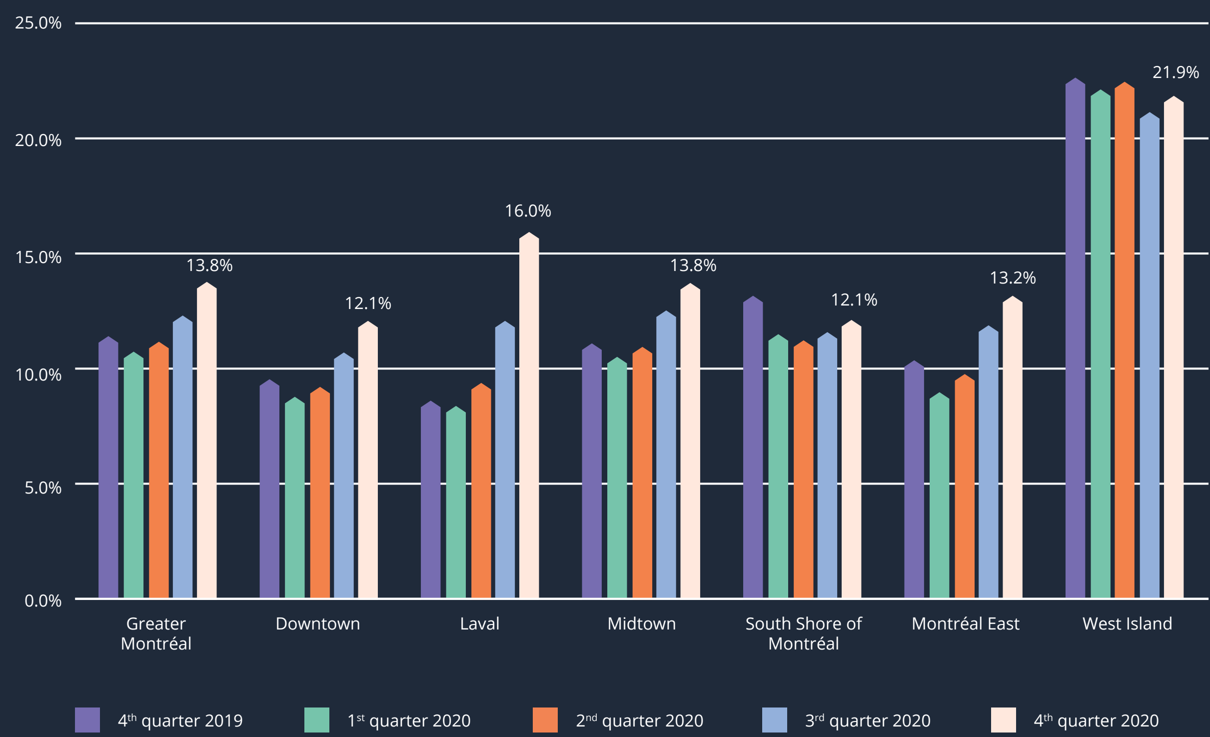
In Downtown Montréal, the beginning of 2020 was promising: the availability rate dipped to 8.8% at the end of the first quarter, after reaching 9.6% at the end of 2019. At the end of the fourth quarter of 2020, nearly 6.5 msf of space were available in Downtown, which represents a total availability rate of 12.1%. Between the end of 2019 and the end of 2020, the sublet availability more than doubled in the city centre. The area available for sublease went from 369,663 square feet (sf) to 853,032 at the end of December, bringing the sublet availability rate from 0.7% to 1.6% of the Downtown inventory.

Generally speaking, availability increased in most submarkets during the year. The Laval market saw its availability rate nearly double, reaching 16.0% at the end of December 2020 from 8.6% at the end of 2019. At the end of the year, nearly 695,000 sf of space were available in Laval, more than 45,000 of which were available for sublease, while just a handful of square feet were available 12 months prior.

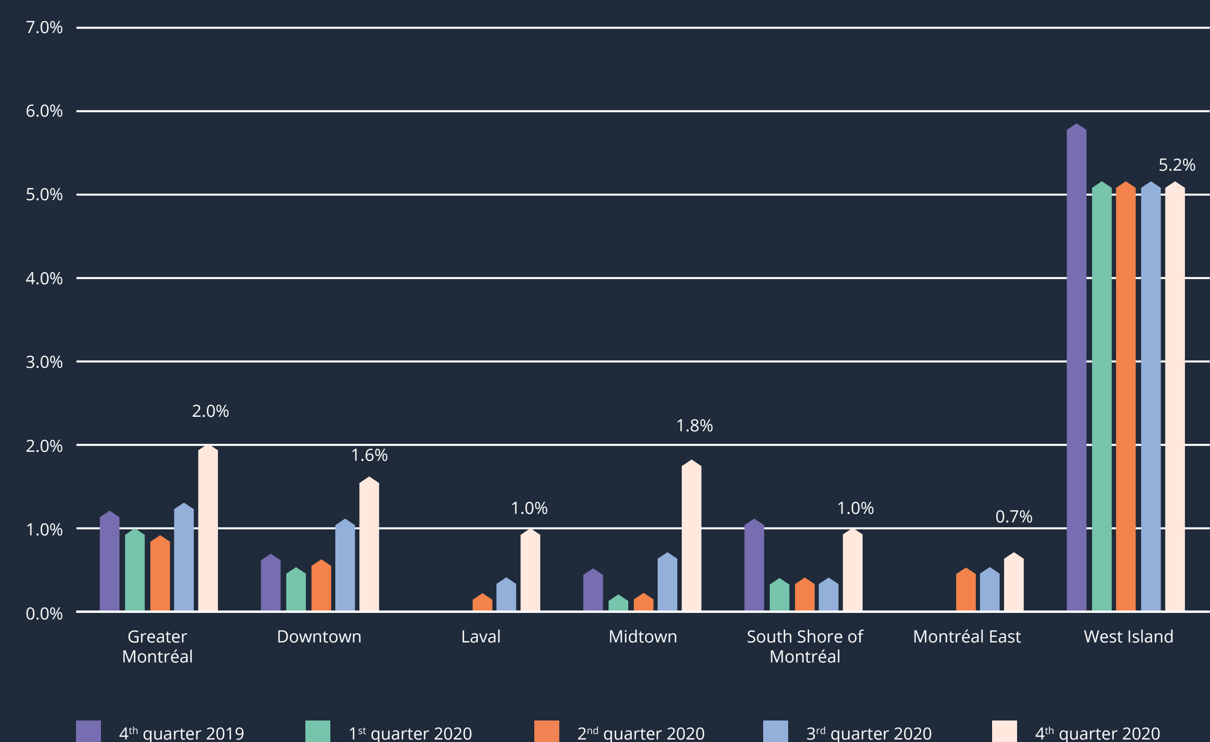
Many agree that the suburbs have not been as affected by the pandemic as the city centres. While this is not the case in Laval, the South Shore of Montréal has performed fairly well in 2020. Its total availability rate dropped from 13.2% to 12.1% between December 2019 and December 2020, after dipping to 11.3% at the end of June, which helped to moderate the generalized increase observed during the last two quarters. The South Shore's sublet availability also decreased year over year, going from 1.1% to 1.0% at the end of 2020. It should once again be noted that the sublet availability rate hovered around 0.4% during the first three quarters of the year.

The eastern portion of the South Shore recorded the lowest availability, as South Shore West is still struggling with higher rates, especially in the vicinity of Solar Uniquartier and Quartier DIX30. Nevertheless, the western portion of the South Shore market still saw a decrease in availability over 2020 as recently delivered product secured new tenancies.

TOTAL AVAILABILITY, GREATER MONTRÉAL



SUBLET AVAILABILITY, GREATER MONTRÉAL



New strategies

While the transactional pace and the deal velocity have continuously slowed down and new rental agreements become more scarce, some companies chose not put their occupancy plans on ice and have taken the opportunity to rethink their office space while adapting to the new reality. As employers are forced to admit that the pandemic will have generated new ways of working, flexibility has become the cornerstone of occupation strategies for businesses.

This is the case of software corporation SAP Canada, which has recently announced the conclusion of a new lease agreement for 66,000 sf of space at 5 Place Ville Marie. In doing so, the company intends to meet the new expectations of its employees with respect to their work environment and flexibility.

SAP Canada will join Marsh, Mercer and Oliver Wyman at Place Ville-Marie, the three Marsh & McLennan entities having also announced at the end of the year that they will set up their Montréal headquarters in 50,947 sf of space on the 15^{th} and 16^{th} floors of 1 Place Ville Marie in the summer of 2021. Less spacious than their previous premises at 1981 McGill College Avenue, the new offices will be designed to offer better flexibility and to promote collaboration and innovation for the 400 employees.

Even when the pandemic ends, some traditional workplace models may change for good. Portfolio strategies may start to shift from a headquarters to a hub-and-spoke mindset with footprint optimization and the human experience as key considerations.
The "hub" would be a central location where some employees work full-time, facilitating branding, culture, collaboration and engagement.
The "spoke" would include flexible workspaces and partial or full-time work from home. The big question that will impact demand is whether tenants will require more, less, or the same amount of office space.

How do landlords see 2021?

The market continues to feel secondary impacts from reduced economic activity and "wait-and-see" disruptions as heightened uncertainty and risk cause occupiers to delay occupancy decisions, investment or expansion plans. For landlords, 2020 has certainly brought its share of learning.

With more than 5.3 msf of office space in its portfolio, **Groupe Petra** is one of the largest players in the Québec commercial real estate sector. For **Isabelle Héroux**, Vice President, Leasing at Groupe Petra, the pandemic highlighted the importance of solid relationships with all stakeholders.

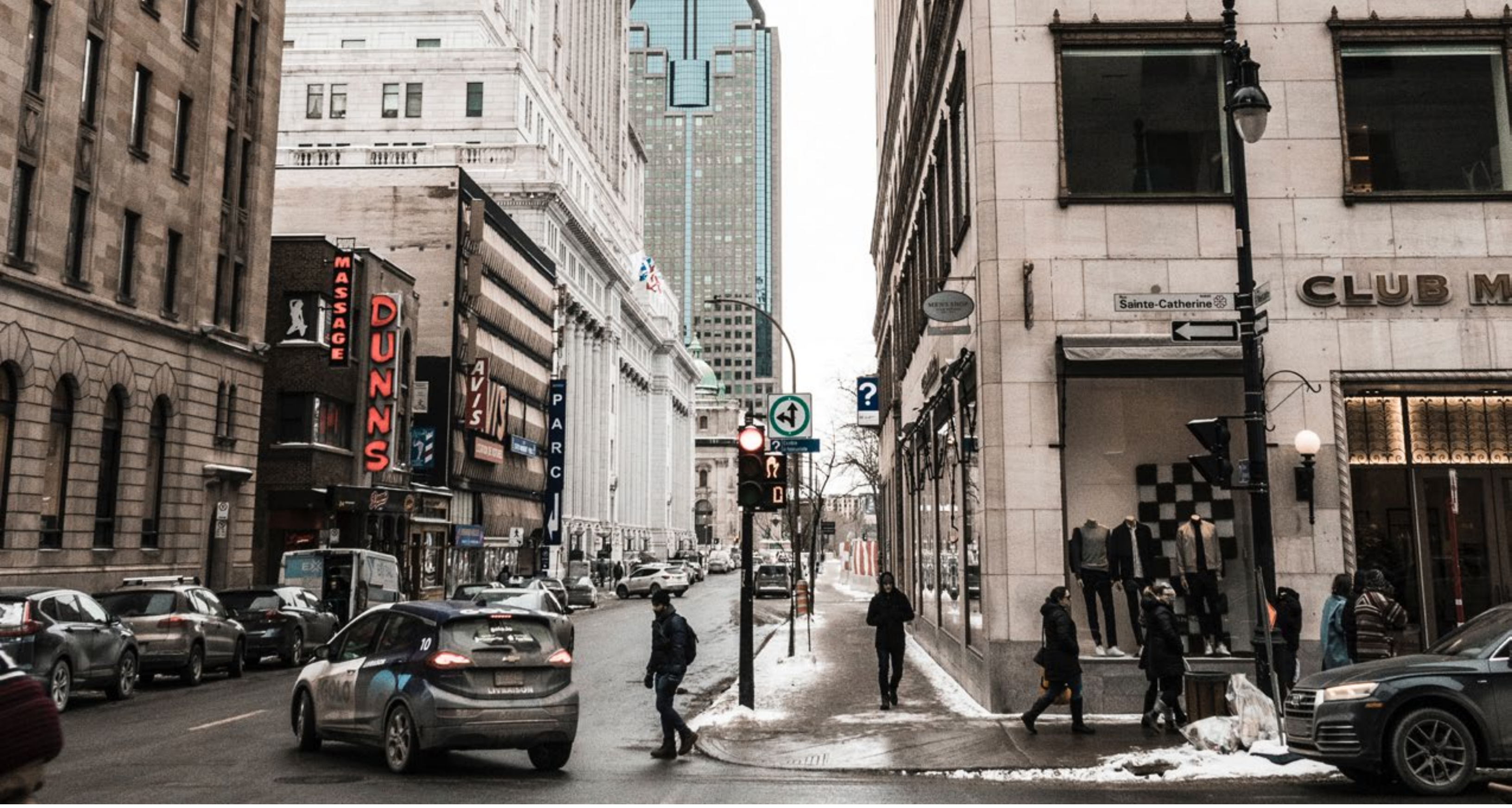
"The year 2020 brought major awareness with regards to our industry, specifically to the importance of our relationships with our tenants and our partners" explains Isabelle. "Groupe Petra has always maintained close relationships with its customers and partners. In the context of a pandemic, further strengthening these ties became imperative. Supporting, listening and understanding our partners was crucial."

However, the pandemic and its subsequent impacts have not hindered Groupe Petra's projects. Groupe Petra maintained its portfolio investment strategy and its plans to modernize certain key assets. "Although the advent of telecommuting influences the human resource management strategies of most companies, we believe it is essential to invest in our properties and adapt to new realities," explains Isabelle.

"Our portfolio benefits from a wide geographic spread and a good asset diversity, which allows us to achieve a healthy balance. While certain types of tenants are rethinking the use of their premises, others are expanding and want to diversify their locations. The market still offers opportunities in this direction, and we have to be attentive."

"We are entering 2021 with confidence, while remaining cautious. We are passionate about what we do, and we care about real estate. Our core values of listening and flexibility will remain essential assets in this year of transition to a new reality, as the coming months will be decisive with regards to how businesses see flexible work. We will support our clients in return-to-office strategies and find the best solutions to support their challenges. Montreal has always been able to bounce back and seize opportunities. 2021 will be no exception."

Isabelle Héroux
Vice President, Leasing, Groupe Petra



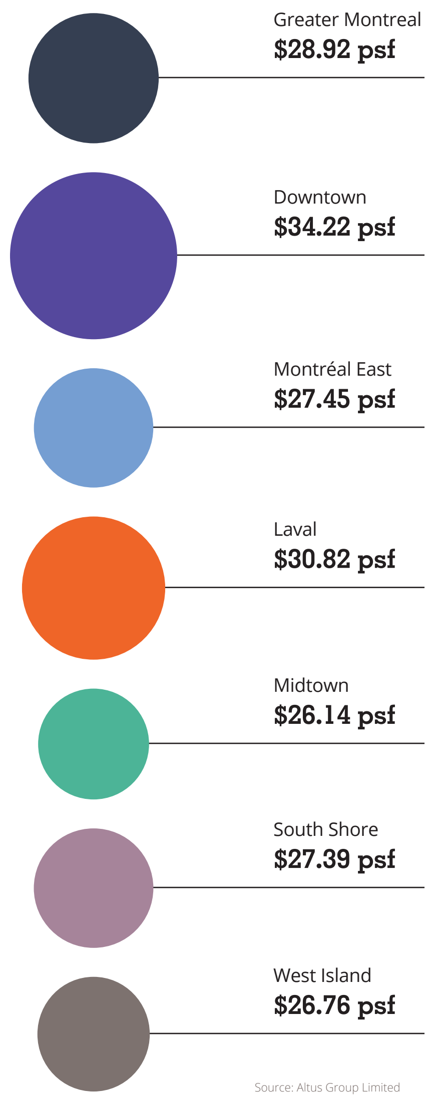
Occupancy Costs

While many were expecting to see some decrease in rents in response to the sharp increase in availability in the recent months, the pandemic did not have the expected impact on occupancy costs thus far. This could change over the next few months, however, as the increase in availability is expected to continue drastically increasing and larger blocks of space become available, tipping the scales in favor of tenants and forcing landlords to adjust their prices.

Average gross rents remained relatively stable for all asset classes in the GMA in 2020. The average stood at $28.92 per square foot (psf) at the end of the fourth quarter of 2020, from $28.63 psf twelve months prior, while asking rents and additional rents have not fluctuated much during the year. Average gross rents for Class A buildings dropped slightly between the fourth quarter of 2019 and the end of 2020, dipping from $34.73 psf to $33.64 psf.

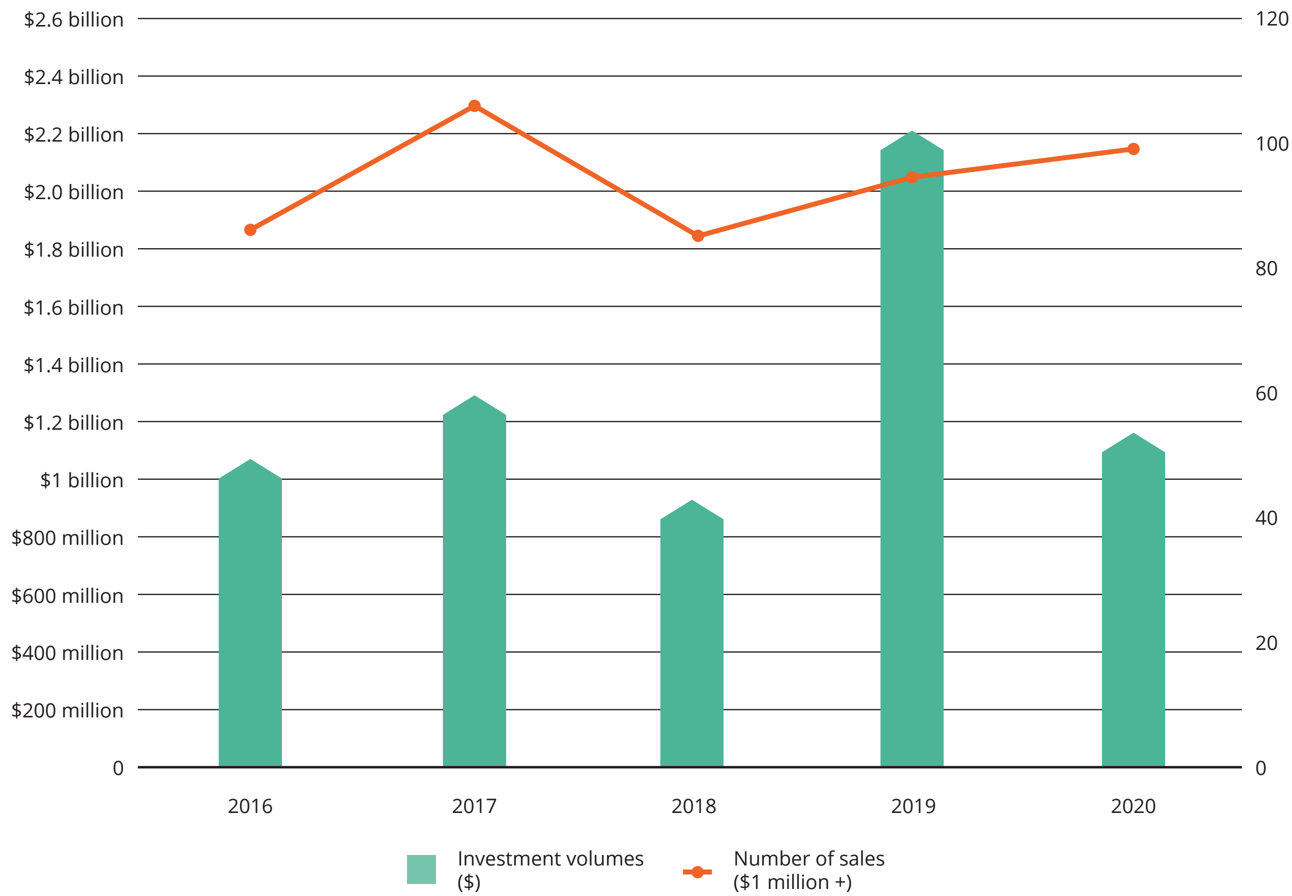
In Downtown Montréal, average gross rents have not changed significantly over the past year either. Gross rents dipped from $34.58 psf in the fourth quarter of 2019 to $ 34.22 psf at the end of 2020. As for Class A buildings in the city centre, gross rents have increased slightly more significantly, averaging $46.78 psf at the end of 2020 from $45.12 psf at the end of the fourth quarter of 2019. Gross rents for Class B buildings Downtown have also increased over the course of the last twelve months, rising from $32.22 psf at the beginning of the year to $33.44 psf at the end of 2020.

As availability is expected to maintain its sustained increase in 2021, asking rents could decline during the year, but the expected repercussions on occupancy costs have not materialized so far, at least not in the Montréal market. If the situation recovers quickly during the year, the current trends could therefore maintain their course.



Source: Altus Group Limited

SALES VOLUMES, OFFICE, 2016 TO 2020



2020

Investment Highlights
Office
Greater Montréal

$1.16B

Total Investment Volume
Office
Greater Montréal

99

Total number of sales
Office, $1 million +
Greater Montréal

$224.63

Average price/square foot
Office
Greater Montréal

Availability Greater Montréal
↑
14,500,558 sf

Occupancy Costs Greater Montréal
↔
$28.92 psf

Availability Downtown
↑
6,445,859 sf

Absorption Downtown
↓
-1,261,050 sf

Investments

The pandemic has led to a deep bifurcation of the country's commercial real estate market while substantially slashing overall investment activity in 2020. Meanwhile, the ongoing tug-of-war between work from home and return to office policies resulted in investors typically interested in office assets remaining on the sidelines, while industrial and multi-residential assets retained most of the investors' attention in Canada.

Nonetheless, the total office investment volumes in the Greater Montréal Area exceeded expectations, reaching nearly $1.16 billion dollars in 2020 according to the data collected at the beginning of February 2021. Office sales only represent 15.83% of the total investment sales for 2020, putting office sales in fourth position behind retail, multi-residential and industrial sales.

It should be noted that 2020 got off to a flying start in January, with the sale of 747 Square Victoria ($276 million), 1100 René-Lévesque Boulevard West ($225 million), 1611 Crémazie Boulevard East ($41 million), 511 Place d'Armes ($25.5 million) and 1200 Chomedey Boulevard in Laval ($18.9 million). Alone, these five sales represent more than half of the total office investment volume for 2020.

It should also be noted that ten of the fifteen largest office sales recorded during the year took place in the first two quarters of 2020, most of which were already well underway before the pandemic struck.

The second half of the year has been characterized by a slightly higher number of transactions, which were generally smaller in size, mostly fluctuating between $1 million and $4 million.

TOP 5 SALES OF 2020

Montréal World Trade Centre
747 Square Victoria, Montréal

$276 million

January 2020
Purchaser: Allied Properties REIT

1100 René-Lévesque Boulevard W.
Montréal

$225 million

January 2020
Purchaser: Groupe Mach

1450 City-Councillors Street
1435 Saint-Alexandre Street
Montréal

$70.2 million

March 2020
Purchaser: Crestpoint/Crofton Moore

1611 Crémazie Boulevard East
Montréal

$41 million

January 2020
Purchaser: Société Galion

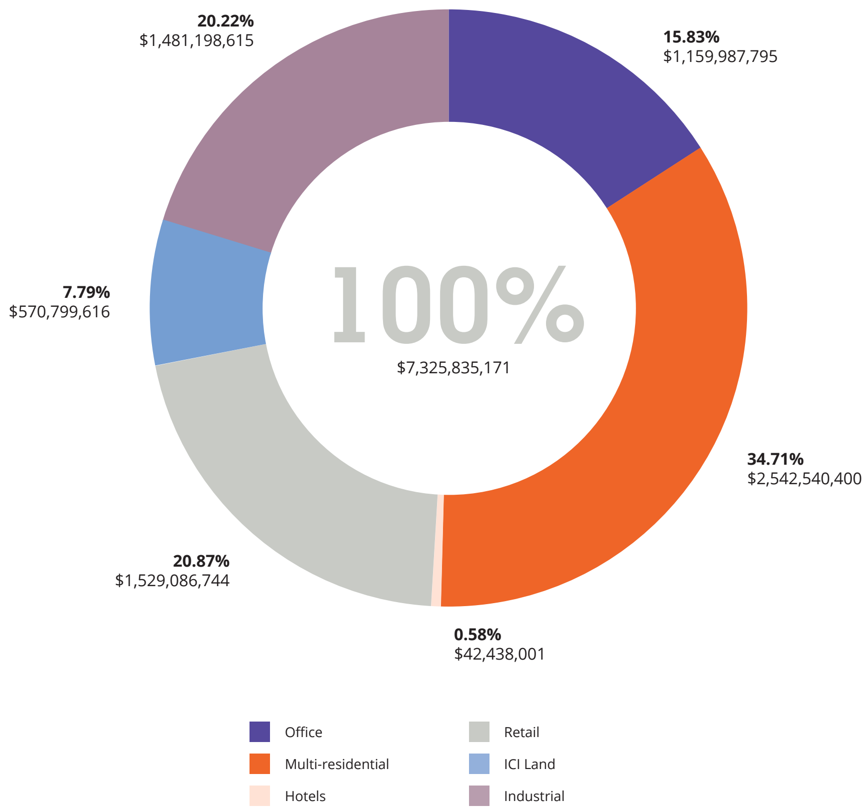

Photo : Groupe Mach

400 Sainte-Croix Avenue
Ville Saint-Laurent

$33.7 million

June 2020
Purchaser: Groupe Mach

COMMERCIAL INVESTMENT SALES VOLUMES, 2020



While central markets have generally seen a marked increase in availability, suburban assets have shown more resilience, as outlined by the current conditions on the South Shore. This is likely to generate interest from investors in the coming months.

Additionally, office buildings in the suburban areas could become even more attractive in 2021 if large Downtown occupiers consider adopting a hub-and-spoke business model or opening satellite offices in the outskirts of Montréal, as employers are attracted by the lower density of the suburban sectors and employees benefit from greater proximity to their residence.

At the end of December, the overall capitalization rate (OCR) for Class A office buildings in Downtown Montréal averaged 5.1% for the third consecutive quarter, with an average unitary price of $433 psf, which is a slight increase compared to the two previous quarters. At the same time in 2019, the average OCR for Class A office buildings in Downtown hovered around 4.8%, while the average price per square foot was of $454 psf.

The average OCR for Class A office buildings in the midtown sectors rose from 5.7% to 5.9% between the end of 2019 and the end of 2020 (after dropping to 5.6% at the end of the first quarter), while average prices have dropped from $307 psf to $297 psf.

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