Quebec’s non-residential real estate market is solid
Investments set to continue rising

Despite the gloom hovering over Quebec’s economy, the dynamics of the non-residential real estate market are conducive to its expansion. The industrial sector in Quebec City is grappling with a shortage and the market in Montreal is gradually getting back on its feet. New construction is even set to expand in several regions in the months ahead. Commercial real estate continues to grow, but new surfaces are about to be introduced in a highly competitive environment that is intensifying due to weak retail sales. In terms of office buildings, several new buildings in Quebec City have steadily eased the shortage while sales and rental activity remain on track. Demand in Montreal is still stagnant, however, which is keeping a lid on new projects and supporting a higher vacancy rate. This Economic Viewpoint takes a close look at the industrial and commercial sectors. The market for office buildings will be examined in an upcoming publication.

CONSTRUCTION IN FULL SWING

Even if Quebec’s economy has been vacillating in recent months, business investment in non-residential buildings has been trending upward for the past two years now. The strike by construction workers in June may have shut down worksites temporarily (graph 1), but many ongoing and future projects will quickly wipe out any lasting memory of this decline in activity. The length of the work stoppage varied depending on the sector and some worksites kept the hammers going throughout the shutdown period, as provided for by R-20, the act respecting labour relations. According to the Commission de la construction du Quebec (CCQ), the strike, which lasted from June 17 to July 1, cut the number of hours worked in June by 38% on the industrial side and by 29% in the commercial and institutional sector. A ramp-up in activity following the strike have more than narrowed the gap left by the work stoppage reasonably well.

Besides this episode, Quebec’s balance sheet on business investment in buildings has been positive since the beginning of 2013. That said, major discrepancies have cropped up between Quebec’s urban centres (graph 2 on page 2). Of the six main agglomerations, the Sherbrooke CMA shows the strongest growth, followed by Trois-Rivières and Quebec City. Advances are more subdued in Montreal due to the stability in the commercial sector. Greater Montreal stands out however due to energetic activity in the industrial sector while commercial construction in Trois-Rivières, Sherbrooke and Quebec City is booming (graph 3 on page 2). Weaknesses observed in Gatineau and Saguenay are largely explained by a steep drop in industrial and commercial construction. The building permits granted to companies also show regional disparities, which confirms that some areas are seeing a slowdown in activity while others are in full swing (graph 4 on page 2). Despite this, industry players across Quebec—from materials suppliers to the professional firms that are active in this field—can all capitalize on the overall improvements.

Graph 1 – The strike in June affected investments in non-residential building construction

Sources: Statistics Canada and Desjardins, Economic Studies
Building permits issued in the industrial and commercial sector have recorded strong growth since the beginning of the year in half of Quebec’s regions (graphs 5 and 6). The positive trend in building permits granted by municipalities (graph 7) suggests that Quebec’s industrial and commercial sector is set to continue to expand. The strong showing in the market for commercial and industrial spaces is supporting sustained activity at worksites.

1 In the Statistics Canada survey on investment in non-residential building construction, the industrial sector includes mostly manufacturing plants and warehouses, while the commercial sector consists mainly of office buildings and retail spaces. The statistics on building permits are grouped similarly.
INDUSTRIAL MARKET: QUEBEC CITY ALREADY IN EXPANSION MODE

The thriving economy in the greater Quebec City region has been a hotspot for industrial real estate for years now. The industry is dealing with a shortage of spaces to rent, buildings for sale and land available for new construction. As a result, rents and sales prices are climbing, which simply pushes up property values. According to Altus Group, the occupancy rate in the 20 industrial zones and parks located within the Quebec City territory is on average 95%, with nine boasting 100% occupancy. The shortage of land is limiting the construction of new industrial surfaces on the North Shore, which has kept the vacancy rate at less than 5% for years.

Once a building is sold, the acquirer usually occupies part of or the entire space. Only about 30 industrial buildings change hands in Quebec City each year and these buildings usually have plenty of suitors. This category of building ranks third in real estate investor preferences in this region (graph 8). The selling prices for industrial properties have risen sharply since 2010. The difference in value between the Quebec City and Montreal markets has just about disappeared, and buildings are changing hands for almost the equivalent prices (graph 9).

According to Altus Group, constructing a new building in Quebec City is often just as profitable as purchasing one. Given the market’s current buoyancy, the new development clusters are taking shape just at the right time. For example, the Espace innovation industrial park created this fall, new land recently put up for sale to support the expansion of the St-Augustin-de-Desmaures industrial park and the availability of several locations on the South Shore, due in most part to Phase 1 of Innoparc industrial project in Lévis, will increase the amount of industrial space in the metropolitan area. Even though the construction of industrial spaces in the CMA has yet to accelerate in 2013, compared with last year, activity is expected to surge in the near future.

The market in Quebec City has few industrial tenants as it is dominated by owner-occupants. Even if the rental market is small, the lack of available spaces is putting upward pressure on rents that now hover between $5.50 and $9.00 per square foot, whereas quality industrial buildings in Montreal rent for between $5.00 and $8.00 per square foot. The market in Quebec City has in recent years narrowed the gap that existed with the market in Montreal, both in terms of selling prices and rents. This evolution reflects the economy’s solid performance and the concentration of technology-based buildings that are less sensitive to the setbacks that affect the global economy. The industrial market in Montreal was more severely impacted by the difficulties in the manufacturing sector, but signs of a recovery are starting to be seen.

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3 Net rent: Includes only the amount charged by the owner to rent the space. Excludes operating costs and property taxes.
Montreal’s industrial market is not as far ahead in the real estate cycle as its counterpart in Quebec City. Stagnation has set in in some zones, while others are starting to see growth (graph 10). Several companies that had reined in development since the recession of 2008-2009 are now in a better financial situation, which supports the demand for industrial spaces. Some companies that held their own through difficult economic conditions have now entered an expansion phase. In the Montreal CMA, investments in industrial buildings are up sharply since the beginning of 2013.

Up to now, the demand for rental space has been quite solid in 2013. Market conditions are fairly well balanced overall, which favours gradual rent increases. According to CBRE, the vacancy rate in Greater Montreal was 8.0% in the second quarter of 2013 and demand for rentals was improving in most sectors. The central neighbourhoods on the Island of Montreal and the South Shore enjoyed enviable occupancy rates while the eastern and western tips of the island, as well as Laval and the North Shore, had more rental units available (table 1). Demand for large spaces with high ceilings is still strong, which is driving market growth.

Sites designed for a single tenant close to the highway are in high demand, which exerts pressure on rents. The market on the South Shore has a low vacancy rate of 4.3% and the extension of highway 30 will encourage future development. On the North Shore, work to complete highway 50 will be critical to the expansion of the industrial market in the Laurentians region. Lastly, in another plus for industries, the opening of the bridge on highway 25 in Laval in 2011 has made the transportation of goods much more efficient along the north-south axis.

In addition to the transportation routes, a few trends are set to shape how the market in Montreal will develop. On one hand, companies in the construction materials business will opt for spaces located near major worksites to reduce operating costs. On the other, the growth of the Port of Montreal is stimulating the development of distribution, transportation and warehousing centres. However, this type of user needs spaces that have sufficient ceiling height. If such spaces cannot be found on the existing market, several companies are turning to custom construction. This type of construction usually takes place on the outskirts of the urban area due to the scarcity of industrial land available on the island.

The rebound in the manufacturing sector, which should take off in the coming quarters due to better growth in the U.S. economy, will jumpstart the industrial real estate market in Montreal. While the situation tilted in favour of tenants last year, the market returned to more balanced conditions in 2013 (table 2). According to Jones Lang Lasalle, the state of the market will continue to move in the right direction,
meaning that owners will be better positioned to expect tenants to meet their conditions as of next year. Most of the markets on the Island of Montreal will, as a result, renew with growth.

COMMERCIAL REAL ESTATE: MORE PLAYERS BUT NO SALES GROWTH
The commercial real estate market has been constantly evolving for decades. The main arteries were the first to be disrupted by conventional shopping centres. The arrival of big-box stores changed consumers’ shopping habits, imposing a period of adaptation for shopping centres. A few years later, retail spaces that are not linked by a mall—some of which have food services or recreational areas—began to emerge, which also changed the real estate landscape. Each development phase brought with it an adjustment period for the existing commercial spaces, and certain spaces became more vulnerable. The current expansion phase will leave its mark and once again shape the role of the players in this industry. Robust construction should, in principle, rely on retail sales growth, increases in rental rates and good profitability generated by existing spaces. Otherwise, the client base will only be diluted, which could weaken the financial position of existing centres.

The commercial sector seems to be in full swing, powered by many ongoing projects and announcements about upcoming projects. The wave of power centres⁴ or lifestyle centres⁵ being built across Quebec is ongoing, and other warehouse stores are popping up in some agglomerations, new banners are being added to the roster of retailers and several regional shopping centres are getting a makeover. In some cases, the revitalization of tired shopping centres is essential for their survival. While conventional shopping centres still have their drawing power, smaller neighbourhood shopping centres⁶ sometimes struggle. Major investments enable these spaces to improve their positioning to better serve consumers.

Beyond the construction, transformation or renovation activity that appears to be bursting with energy, the health of the commercial real estate market also depends on consumers’ capacity to absorb all these new surfaces. Yet, the surge in the construction of new points of sale does not appear to be justified by a sharp spike in consumption. Instead, retail sales in Quebec have been almost stagnant for some time now (graph 11). But while this industry evolves in a highly competitive environment, the profit margins are still shifting in a positive direction (graph 12). Some regions are doing better than others however, since the population—directly tied to sales potential—is growing faster in some regions than in others (graphs 13 and 14 on page 6). The market’s momentum and the prevailing risks may vary considerably as a result, depending on where a business is located, as the significant disparity in rents attests (graph 15 on page 6).

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4 A cluster of big-box stores not linked by a mall.
5 Same as in footnote 4, but with food courts and entertainment.
6 By conventional shopping centres, we are referring to shopping centres with big-box stores attached to an indoor mall. Regional centres are somewhat smaller in size and neighbourhood shopping centres are usually limited to a grocery store and a few adjacent retailers.
If some players are doing well by multiplying their points of sale to serve customers, this is usually done at the expense of long-established retailers or new chains that are having trouble carving out their niche. The recent arrival of Target in Quebec will be a good market test: seven new stores opened in September (in Brossard, Laval, Lévis, Place Vertu, Saint-Georges, Saint-Jérôme and Trois-Rivières) in the spaces left vacant by the now defunct Zellers, which was mired in severe financial difficulties. This expansion phase will further divide retailers into two camps: the winners who chip away at market share and solidify their financial position, and the losers who will find it increasingly difficult to keep up in this highly competitive environment. The players in the commercial real estate market will also have to adjust to this reality, where excellent business opportunities abound for some while others will have to deal with higher risks.

MANY DEVELOPMENT CLUSTERS

Despite this reality, Quebec is brimming with development clusters. In the Montreal CMA, the expansion of the Faubourg Boisbriand is ongoing, phase 4 of the Quartier DIX30 is about to break ground in Brossard, while the construction of the Faubourg Châteauguay is underway in the surrounding areas. In the Quebec City area, the real estate boom in Lévis is clearly visible. Three phases are in the works for the Carrefour St-Romuald, which will require a total investment of about $500 million. The first step will see new businesses set up shop, such as warehouse stores and specific niche boutiques. Projects for a total of $800 million are in the pipeline in Trois-Rivières for the District 55. The wave of expansion is therefore quite widespread across the province.

LOOKING TOWARD THE FUTURE

The situation in Quebec’s economy will solidify the outlooks for the non-residential real estate market. The expected recovery in the manufacturing sector has to materialize to strengthen the industrial market’s foundations. The expansion in the U.S. economy, which appeared set to firm-up, will be a determining factor. The commercial sector’s expansion will be supported by advances in retail sales, which need to keep gaining traction. Improvements in the employment market and household confidence are also needed to absorb the newly added surfaces without causing too much harm to existing spaces. Some regions are benefiting from more favourable demographics however, and will thus do better than others.