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They're coming to…Canada?

Large numbers of immigrants may continue to make Canadian real estate an attractive investment…

Update
30 December 2022

Analysts:
David Kimberley
david.k@keplerpartners.com

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At the start of November, the Canadian government updated its immigration targets for the next three years. Authorities in the North American nation are aiming to have 465,00 new permanent residents in 2023, 485,000 in 2024 and 500,000 in 2025.

If these numbers become a reality, it would result in population growth of close to 4%. It will also continue a pattern we've seen over the past couple of years, as the Canadian government has sought to encourage immigration to grow its economy and prop up an aging workforce. Indeed, by the end of this year, it's likely that at least 430,000 new immigrants will have arrived in Canada.

Whether or not you believe these are good policy decisions, it's hard to see them not having a meaningful impact on the Canadian economy and one area where this is likely to be particularly pronounced is in real estate.

According to Canada's state housing agency, the Canada Mortgage and Housing Corporation, there is going to be a shortage of 3m housing units by 2030 in the country if current demographic trends and building rates continue. This is despite the fact that housing is already more expensive, relative to average income, than at any point since the early 1990s.

It's this dynamic that explains why the managers of **Middlefield Canadian Income (MCT)** find Canadian real estate such an attractive proposition. In a tough 12 months for markets, MCT has managed to deliver positive returns for shareholders. That's in large part because of the commodities and financials businesses in its portfolio, which make up a large proportion of Canada's stock market. But the trust also has a large weighting, equal to a little over 25% of the portfolio, in real estate investment trusts (REITs).

For the residential REITs in the portfolio, the supply and demand dynamics described above are likely to be the main driver of returns in the years ahead. However, there are other factors at play too.

Like its southern counterpart, Canada's central bank has been aggressive in hiking interest rates to counteract inflation this year. The most recent 50bps took place on December 7th and means the base rate for the Bank of Canada now stands at 4.25%.

This has filtered on to mortgage providers, who are now charging home buyers much more to borrow. A quick scan of Canadian mortgage price comparison site WOWA shows that the lowest fixed-rate mortgage available is 4.5%.

As a result of this more people are renting properties instead of buying them. According to Canadian property letting site Rentals, the average monthly rent paid by Canadians was 12.4% higher in December this year compared to 12 months ago. In commercial centers like Toronto and Vancouver, the figure was typically over 20%.

More housing would alleviate these problems but here too there are problems which seem difficult to surmount. Materials are now much more expensive due to inflation and labour costs are also high because of a shortage of workers.

Some local authorities have also increased taxes for building new residential sites. For instance, Toronto's city council announced it would be hiking these rates by 46% in August. The result is that a company building a new two-bedroom apartment in the city will have to pay local authorities over CAD$80,000. Perhaps unsurprisingly then, real

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estate research firm Urbanation has found that a third of developments in the Greater Toronto Area planned for 2022 have been cancelled.

All of these dynamics should create positive tailwinds for the residential REITs in the MCT portfolio. But Canadian REITs have seen their discounts widen substantially so far in 2022. Many of MCT's holdings, for example, have ended up trading at 30% discounts to their net asset value (NAV) and the trust itself is now trading at an almost 11% discount.

This seems largely due to real estate's sensitivity to interest rate hikes, which have historically led to falls in property prices. That possibility should not be ignored and it remains a real risk.

However, with many REITs now trading at steep discounts, there's an argument to be made that any fall in valuations which may stem from rate hikes has already been priced in. There have also been some reassuring signs here. In early December, investment group Blackstone acquired six industrial sites in Toronto. The group paid CAD$270 per square foot. Similar industrial REITs in the MCT portfolio are currently valued at CAD$170 per square foot, or nearly 40% below the rate at which the Blackstone acquisition just took place.

And even though discounts widening hasn't been positive for MCT's short-term performance, they've also enabled MCT manager Dean Orrico to add to existing positions this year in Canadian Apartment Properties REIT and Granite REIT, which invests in logistics and industrial sites.

That's not a guarantee of success, nor does it mean short term volatility is likely to dissipate. However, it's a sign that the managers remain confident about the long term prospects of Canadian real estate. And given the Canadian government's own immigration plans, as well as the favourable economic environment currently in play, it's easy to understand why that's the case.

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