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ARE REITS SET TO SHINE AS INFLATION COOLS AND RATE HIKES END?

Middlefield's Dean Orrico discusses the increasingly attractive investment opportunities in Canadian real estate

With inflation finally subsiding and central banks starting to tap the brakes on further interest rate hikes, investors are turning their attention to Real Estate Investment Trusts (REITs).

It was a challenging year for REITs in 2022. The remarkably rapid increase in interest rates sent shivers through the property market and sharpened the appeal of alternative fixed-income investments.

But with rates now nearing the peak of their cycle and Canadian property showing signs of recovery, REITs are regaining the attention of investors. And as a leading portfolio manager of REIT investment funds, Middlefield Group is perfectly positioned to shed light on what comes next for North American real estate.

"It was a tough year in 2022," acknowledges Dean Orrico, the CEO of Middlefield, during a recent interview with Wealth Professional. "Then we had a number of banks fail in the US and Europe, which created another headwind because banks are lenders to commercial real estate."

"But fast forward to today – with the banking crisis ring fenced and the cycle of rate hikes in its final innings – we're very positive about the outlook for real estate, especially publicly listed REITs."

Orrico says publicly listed REITs are now trading, on average, at a 25% to 30% discount to net asset value (NAV), providing a very attractive entry point for investors who had moved to the sidelines during a uniquely challenging year in 2022.

Founded in 1979, Middlefield is a global investment firm whose investments range across a variety of industries. Within its real estate strategies, Middlefield's portfolios are allocated across several key focus areas; including industrial, multi-family, and open-air necessity-based retail properties.

It's a robust suite of funds with impressive track records. Middlefield's Real Estate focused mutual fund has won the Refinitiv Lipper Fund Award for best real estate fund for 2-years running. Through active management, attractive pricing, and tax-efficient monthly distributions to investors, Middlefield has a well-deserved reputation as one of Canada's leading managers of REITs.

Asked what he expects for the year ahead, Orrico says some real estate sectors are poised to outperform, particularly multi-family and industrial properties.

Industrial REITs

Industrial REITs represent properties that are usually used for warehousing and other logistics operations. This year they are benefiting from a confluence of factors affecting both supply and demand.

"Vacancy rates there are about as low as we've seen them, averaging about 2%," Orrico says. And with the high cost of construction holding back supply, rents rose about 28% in the first quarter of this year.

"These industrial properties are doing very well, with the higher rents more than offsetting the increase in interest costs."

Multi-family REITs

The slow pace of construction is also affecting residential properties – which are in such short supply that Canada has the lowest amount of housing per capita in the G7.

This chronic shortage of housing is now running up against a record intake of new immigrants, and together they are contributing to a perfect storm of limited supply and rapidly rising demand.

And these conditions aren't expected to change anytime soon. Canada is targeting about 500,000 new immigrants annually for the next few years -- at the same time that housing supply will continue to be constrained by slow permit approval and a high cost of borrowing for new builds.

"Multifamily REITs are well positioned," Orrico says. "Nearly three in four Canadians live in one of Canada's large urban centres and the supply and demand picture is particularly attractive in Canada's 6 largest markets."

Retail REITs

It's been a different story for retail REITs over the years. The rise of ecommerce dried up consumer traffic in shopping malls and select brick-and-mortar outlets.

But retail REITs have spent this period adjusting their property portfolios, with weaker retailers being steadily replaced with more robust tenants.

"In the last seven or eight years, our retail REITs have done a good job right-sizing their portfolios, and that continued through the pandemic," Orrico says. "Case in point, although Bed Bath Beyond basically shuttered some 65 stores in the Canadian market earlier this year, every one of those locations has been re-leased to a new tenant."

Orrico also says the properties owned by publicly listed REITs in Canada have been sheltered from the worst impacts of ecommerce and the pandemic.

"Our retail REITs are really focused on properties that are anchored by grocery stories or other necessities," he says. "They also have massive land banks surrounding a Walmart or Loblaws that are now being converted into higher value uses, such as self-storage facilities, condominiums and apartment buildings."

What to do about Office REITs?

The pandemic and rise of remote work have had a significant impact on offices, where Orrico says there's 18% to 19% vacancy rates across Canada.

The office sector will continue to face challenges and Orrico suggests the challenges in office are somewhat reminiscent of what he saw in the retail sector over the past 10 years.

The vacancy rate is skewed by much higher vacancies in older office buildings that have poor natural light and inadequate amenities. "At the other end of the office spectrum, new office properties with high environmental standards and good retail outlets and other amenities nearby continue to do very well," Orrico says. "They're 90% plus leased."

"The way it's going to unfold is that high quality offices will continue to be significantly occupied, while lower quality offices may become uneconomic and converted into apartments or condominiums over time. Having said that, converting offices into other formats will not be easy or appropriate for every asset."

It's been a challenging time for REITs, but with inflation and rate hikes beginning to wane, Orrico says there's now an opportunity to enter the market at attractive prices.

Publicly listed REITs in particular have historically delivered a very dependable stream of income for investors. And now -- together with clear tax efficiencies and a powerful tailwind of slow construction and record immigration -- the outlook for REITS is looking brighter.

"The negative sentiment toward real estate in the last year has created a unique opportunity for publicly listed REITs today," Orrico says. "I've rarely seen this combination of positive fundamentals and discounted valuations. It's an exciting time to be a real estate investor."

View the related video interview at **www.middlefield.com**