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MIDDLEFIELD: CANADIAN HOUSING SOLUTIONS WITH CAPREIT

CAPREIT CEO Mark Kenney shares insights in another fireside chat with Middlefield: exploring Canada's housing dynamics and CAPREIT's investment prospects

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If Mark Kenney could magically alter Canadian government housing regulations, his wish would be for provincial governments to adopt a more welcoming stance toward businesses, inviting them with open arms to invest in the housing sector.

In a fireside chat with Middlefield CEO Dean Orrico, the CEO of Canadian Apartment Properties Real Estate Investment Trust (CAPREIT) discussed key issues facing the multifamily sector in Canada. CAPREIT is a top-10 holding in Middlefield's dedicated real estate funds. The firm's real estate-focused mutual fund, Middlefield Real Estate Dividend ETF, received a FundGrade A+ award for 2023.

With a rich history spanning over four decades, Middlefield Group, an independent equity income manager, has a demonstrated track record in managing real estate-focused investment funds. The firm actively manages its portfolios with a focus on leading real estate companies known for their dependable income, prudent debt management, and increasing dividend yields.

Among the various sectors, multi-family REITs stand out as particularly attractive, and are a key focus area in Middlefield's real estate strategies. The sector is highlighted by Orrico due to its ability to increase revenues amid rising construction costs, high land prices, and a shortage of skilled labor in Canada. It's now well accepted by industry players and all levels of government that the country's demand for housing is far outpacing supply; some four to five million new homes need to be built over the next seven years to bring equilibrium to the market. This means building roughly 1,500 homes per day, or over 500,000 homes annually, versus the historical average of 200,000 to 250,000 new homes per year. Given this formidable gap, REITs like CAPREIT are highly attractive long-term investments, offering potential growth opportunities well into the next decade and beyond. day, or over 500,000 homes annually, versus the historical average of 200,000 to 250,000 new homes per year. Given this formidable gap, REITs like CAPREIT are highly attractive long-term investments, offering potential growth opportunities well into the next decade and beyond.

Provincial regulations: fostering investor confidence

Having had over thirty years of experience in the multi-family housing sector, Kenney emphasizes the importance of provincial regulations in providing stability and clarity for investors. He highlights the need for all levels of government to foster an environment conducive to business and investment in the housing sector. Kenney calls for measures to streamline regulatory processes and eliminate barriers to housing development.

Addressing the affordability crisis, Kenney acknowledged the challenges faced by Canadians, particularly younger generations, in accessing affordable housing. He emphasized the need for a multifaceted approach to address affordability issues, including increasing supply and implementing effective demand-side measures.

"I have to clarify for a lot of folks – I'm very upset about the housing crisis as a Canadian, as a dad, as someone who cares deeply about what's going on in local communities. However, from a CAPREIT portfolio point of view, the fundamentals are unbelievable," says Kenney.

Canada is witnessing a significant population-growth issue, primarily driven by immigration, without a thoughtful plan to accommodate the influx of people.

Tackling affordability: a comprehensive strategy

Kenney underscores the need for decisive policy responses to address the housing crisis, including both supply-side measures and constraints on demand. He discusses the challenges posed by population growth and the lengthy timelines for housing development, stressing the importance of a sensitive plan to accommodate newcomers.

> *"The reality is, we can't solely rely on new construction to bridge this gap. Acquiring existing buildings in economically distressed areas, often at a fraction of the cost of new construction, is a much more efficient strategy"*
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> **Mark Kenney, CEO**
> **CAPREIT**

"We're not going to have balance for at least two decades unless a significant intervention occurs. We need to adopt an approach akin to wartime efforts to address the housing shortage our future generations will face.

"It takes 20 minutes to process a family of four at Pearson into the country, and it takes seven years to build their home. We cannot catch the CMHC balance predictions in this period of time. With new policies, governments are doing the right thing – looking at HST, for example, as a rebate to constructors is a great step," Kenney adds.

Any government tackling this issue must address both boosting housing supply and curbing demand. It requires an approach unprecedented in Canadian history. Unfortunately, Kenney feels, this reality isn't fully grasped by the general public. Many assume that lowering interest rates will make housing more affordable, but the likely outcome is a further surge in property values. Consider this: Canada is experiencing a unique intersection of rapid population growth and dwindling home construction rates, a scenario never encountered before in Canadian history. It's a chaotic situation.

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> **Mark Kenney, CEO**
> **CAPREIT**

Infrastructure and development: unleashing potential

"If you glance out a window in much of Toronto, you'll be met with an endless skyline of condominiums. We implemented a foreign homebuyers ban, following in the footsteps of Australia, albeit with a different focus," Kenney says. "Australia targeted single-family homes in subdivisions, safeguarding them for local families. In contrast, Canada's ban on foreign investment in condos effectively halted a longstanding source of investment in rental properties in the country. It's perplexing why foreign investors are being vilified for contributing to the rental market."

Governments expect businesses to resolve the housing crisis, while businesses look to the government for solutions. The bulk of Canadian immigration is primarily concentrated in major cities like Toronto, Vancouver, and Montreal, which Kenney refers to as "islands" due to their geographical constraints. Despite vast expanses of land across the country, housing remains unaffordable due to the lack of municipal infrastructure.

Without basic services, multi-family construction is unfeasible on untouched land. So how do we unlock this potential? Canada is reliant on financially strained municipalities to provide infrastructure, which hinders the availability of affordable land. Contrast this with approaches in major cities like Dallas, Texas, where they use municipal utility districts, allowing the private sector to develop infrastructure more efficiently and at lower costs. It's a conversation sorely missing in Canada.

Kenney stresses, "Let the private sector build it and hand it over to the municipalities. They do it 30 percent faster and 30 percent cheaper. That's not anything we're even talking about in Canada."

Improving returns: newer assets with higher upside

CAPREIT has been implementing a strategy over the past couple of years focused on divesting itself of older, lower-quality assets and reinvesting that capital in newer assets. This approach has proven to be a net positive, yielding higher internal rates of return (IRRs) for CAPREIT. Essentially, by shedding lower-performing properties with higher maintenance costs and reallocating resources to newer rental stock, CAPREIT is able to enhance the overall quality and performance of the portfolio. This not only increases the attractiveness of CAPREIT properties to tenants but also generates stronger financial returns for investors over the long term.

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	Active management 25+ year history with intimate knowledge of the REIT sector evidenced by long-term outperformance vs. peers and benchmark
	Strong REIT balance sheets REITs have solid balance sheets, access to debt, and ample liquidity
	Built-in growth for high-quality assets Market rents are above in-place rents for many of our portfolio companies
	Limited supply coming to market New supply, especially in Canada, is down significantly due to high development costs and interest rates

Kenney says, "We've discussed the possibility of selling a stratum of our portfolio to the government for conversion into social housing. Personally, I've been advocating for this approach because I believe it's crucial to addressing the social housing deficit in Canada. Surprisingly, Canada has fewer social housing units per capita than the United States, despite our reputation as a more socialist-leaning country.

"The reality is, we can't solely rely on new construction to bridge this gap. Acquiring existing buildings in economically distressed areas, often at a fraction of the cost of new construction, is a much more efficient strategy. We're fully supportive of this initiative and willing to work with the government to make it happen.

"While progress has been slow, we've made some headway with announcements and discussions. I'm even open to considering different valuations when selling to non-profit organizations versus the private market, as a gesture of good corporate citizenship. Ultimately, we're committed to moving ahead with this strategy to contribute positively to addressing the social housing challenge in our country."

Reduced interest rates could spark renewed investor interest in REITs

REIT areas set to benefit from a rotation back toward the asset class
Multifamily Affordable housing shortage
Industrial Re-leasing spreads robust even with rent growth slowing
Necessity-based retail Tenant quality and mix have never been better
Specialized REITs Real estate supporting the digital era
Healthcare Occupancy growing and costs declining

Source: Bloomberg, ICI Money Market Funds

The impending REIT revival

Unlike the private real estate market, the REIT sector has experienced a decline in the past couple of years. Middlefield is eagerly anticipating its recovery, particularly given the strong fundamentals evident in companies like CAPREIT. Many of the challenges of the past couple of years have dissipated. Now, a new challenge has emerged, which Kenney dubs the "boogeyman," and that's the perception of being in direct competition with GICs.

Instead of viewing real estate companies as competition, many investors are now considering GICs their primary option for steady income. They are opting to wait on the sidelines until the market settles. This strategy may backfire, however, as a resurgence in REIT prices could happen quickly, as it did in late 2023, while GIC yields decline due to Bank of Canada rate cuts, which are likely in the coming months.

Kenney responds, "I believe these investors may overlook the capital appreciation potential offered by REITs. Ultimately, our performance is heavily influenced by factors like the 10-year bond, which affects the entire sector." Therefore, while income is important, neglecting the potential for capital appreciation in REITs could be a missed opportunity for investors.

Orrico concurs and asserts that it would be a misstep for Canadian investors to await an "all-clear" signal on rates before investing in REITs. He emphasizes that professional money managers are already positioning themselves for a strong rebound, as evidenced by the surge in recent merger and acquisition (M&A) activity. For instance, Blackstone's recent announcement of the US$10 billion acquisition of multi-family-focused AIR Communities REIT, coupled with the earlier acquisition of Tricon Residential REIT for US$3.5 billion in January, underscores this trend.

Forward-thinking investment managers like Middlefield swiftly navigated away from troublesome sectors that have burdened the entire real estate market, such as office real estate. Instead, they have strategically aligned themselves to capitalize on segments like multi-family housing, anticipating a near-term revival in share prices once investors flock back to high-quality, income-producing assets. Orrico emphasizes that five percent risk-free returns on GICs will soon be in the rearview mirror, and Canadians need to act soon to capitalize on opportunities in the REIT sector. Investors looking for areas in which to re-deploy their cash can learn more about Middlefield's award-winning real estate funds here:

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