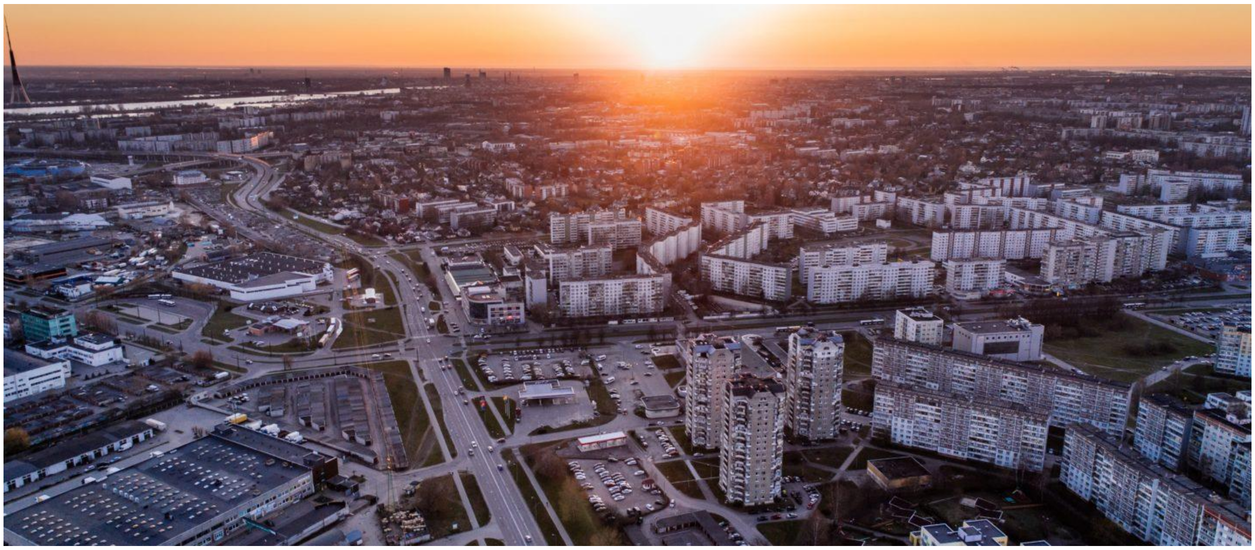

Real Estate's Next Challenge – Fund Composition

By Mark Hannah, Managing Director, Nicola Wealth Real Estate

Amidst the COVID-19 pandemic, there has been much anticipation regarding monthly rent collection. Successful real estate investment is dependent on timely payment of rent by tenants so that owners can pay operating costs, property taxes, mortgage payments and distribute cash flow to investors.

In a recent newsletter, we provided an update on our Nicola Wealth Real Estate Funds focusing on rent collection for the month of April.

Data points collected throughout the industry in April provided valuable measurements on real estate portfolios for owners and fund managers globally. It was a sobering reality that allowed an assessment of how portfolios perform under extreme circumstances.

Fund Composition

Some owners and fund managers strategically focus on one asset type and/or one specific geographic market. Others elect to manage a diversified portfolio. Depending on the makeup of the portfolio, each of these strategies could have proven to be either resilient or devastating.

As the real estate industry assesses the damage from April's findings, attention will shift to fund composition and potential changes required to bulletproof a portfolio in preparation for the next economic event. The consistent theme among owners and fund managers is that there will be greater emphasis on high performing assets and/or geographic markets within their portfolios. This defensive approach will potentially result in lower returns but will be designed to weather future storms.

The other interesting trend unfolding in real time is an understanding of how tenants may utilize real estate in the future; this will impact the future demand for certain asset types. For example, office space; will the increase in remote work practices negatively impact the demand for space? Will space requirements increase to allow for social distancing in an office environment? Will there be a need for plexi-glass barriers for work stations similar to those that restaurants and retail stores have adopted to protect employees? These measures are likely not temporary. One thing is certain; some component of work from home will be adopted by many companies and will put a spotlight on the increased demand for enhanced technology and heightened computer security.

Other asset types such as industrial, self-storage, and multi-family rental apartments may be less impacted but will not be exempt from the virus backlash whether that be for amenities, safety or layout. Tenants are assessing how their business and/or personal use are impacted from the COVID-19 pandemic and how they need to adapt which will dictate their future space needs.

Asset Types

Many owners and fund managers will be forced to make major changes or will have to make adjustments with specific asset types based on their funds performance. They will look to de-risk their portfolios and stress testing on new potential acquisitions will be more rigorous. There will be a flight to quality in order to safeguard portfolios. Other assets, severely impacted by rent impairment or valuation downgrade, will require repositioning, repurposing or liquidating to shore up portfolio weightings.

Here is what the real estate community learned over the past 30 days:

Multi-family rental apartment and industrial properties were excellent performers as both asset types collected in the range of 95% or higher of expected rents. Office assets also performed well but at a slightly lower recovery in the 92-94% range. All three of these asset classes should be considered as the TOP 3 in any diversified portfolio. The emphasis should be on multi-family rental apartment followed by industrial then office.

The Retail segment has suffered greatly in this challenging environment. Many owners and fund managers will be questioning the allocation of this asset type within their portfolios. It is important to discern between the different types of retail as they each have unique benefits and drawbacks. Enclosed malls were forced to close; as a result, owners collected between 25-35% of the budgeted rent. Once the shutdown is lifted, it is anticipated the recovery back to pre-COVID -19 levels will take a very long time, possibly several years. Even then, e-commerce is likely to continue to negatively impact many bricks-and-mortar retail properties. Alternatively, food–anchored shopping centers have performed much better than expected as many of these neighborhood centers are exempt from e-commerce threats – for now. All this will accelerate the online purchasing of food. It has obviously been slow to adapt but as our kids start buying more than our parents, this too will go on-line. The performance of these centers is in the 75-80% range, well below the performance of the TOP 3 asset types listed above. Many owners & fund managers will likely want to reduce their retail exposure unless they can find a way to reposition these under-performing assets.

Other asset classes in real estate include hotels, self-storage and seniors living. Hotels have also been severely impacted and may never be the same as people will be slow to travel for business and pleasure. Self-storage has been a bright light and is controlled by a small ownership fraternity. The rent recovery for this asset class has been surprisingly strong in the 92-94% range or higher. Minimal staff is required to operate these facilities, resulting in lower overhead, and consumers can book units online. Seniors Independent Living, also performed very well in the 95% range for rent collection. Rent collection is viewed as reliable in this asset class; however, the real concern is keeping the residents safe from infection during any future events such as the current pandemic.

Transaction activity has slowed significantly, so it is too early to tell how cap rates and valuations will be impacted for each of the asset classes over the medium to long-term. However, based on early indication and discussion with leading appraisal firms, investor sentiment towards multi-family rental apartments and industrial assets remains by and large unchanged. Certain retail assets on the other hand could see a more pronounced change in cap rates as the landscape for retail continues to evolve.

Geographic Markets

There is a tendency for most owners and fund managers to concentrate on the major markets while focusing on the key fundamentals and economic drivers that benefit a particular asset type. These major markets, however, are crowded with capital which provides attractive liquidity but also causes yield compression. Savvy owners and fund managers will still allocate a large portion of their portfolio to the major markets but will also be forced to consider strong secondary markets to source the desired asset types at attractive returns.

Nicola Wealth Real Estate's Strategy

Since late March, our Nicola Wealth Real Estate (NWRE) Team has focused on rent collection for our Canadian and US income properties. The results for April were pleasantly strong recording 92% collection for Nicola Canadian Real Estate LP (NCRE LP) and 96% for Nicola US Real Estate LP (NUSRE LP). May rent collection is well underway and the results are tracking very similar to April. The composition of assets in each of the NWRE funds is proving to be resilient however there is still room for improvement to fine tune the allocations as we move forward with future acquisitions.

Nicola Wealth's Real Estate Team's Four Pillar strategy is Cash Management, Tactical Asset Management, Diversified Portfolio and Debt Management. This disciplined approach has served us well and we will continue with this strategy during this challenging environment and beyond.

We have strong capital reserves and plan to fortify our portfolios while at the same time maintaining conservative levels of liquidity to meet mortgage obligations and distribution commitments.

To further bolster our portfolios, we plan to pursue the TOP 3 asset classes: Multi-Family Rental Apartment, Industrial and Office. This will be accomplished in a number of ways including acquisition of existing properties and development from ground up with our build to own strategy.

NWRE has assembled a talented and experienced team of specialists to execute on this strategy including mortgage debt, development and leasing specialists to complement our asset managers, finance and acquisition team members.

Summary

Only eight weeks ago, many of the leading real estate fund managers believed that the government imposed lockdown would continue for several months, well into the Fall 2020, but there are already signs of easing restrictions and the adoption of a safe return to the workplace on a gradual basis. If this plan is implemented successfully, it will greatly benefit real estate and the overall economy.

There is no doubt that real estate performance in the COVID-19 environment will be impacted and expectations on returns for 2020 will be significantly adjusted to reflect the new reality. A good outcome will be a mid-single digit return.

As owners and fund managers gain better understanding of income stability, property valuations and liquidity of their portfolios, acquisition and disposition activity is expected to be vibrant due to the large amount of capital on the sidelines and the strategy of fortifying or re-positioning portfolios.

We will continue to keep you informed of the state of the industry, the continued efforts to adapt, and the performance of our real estate portfolio.