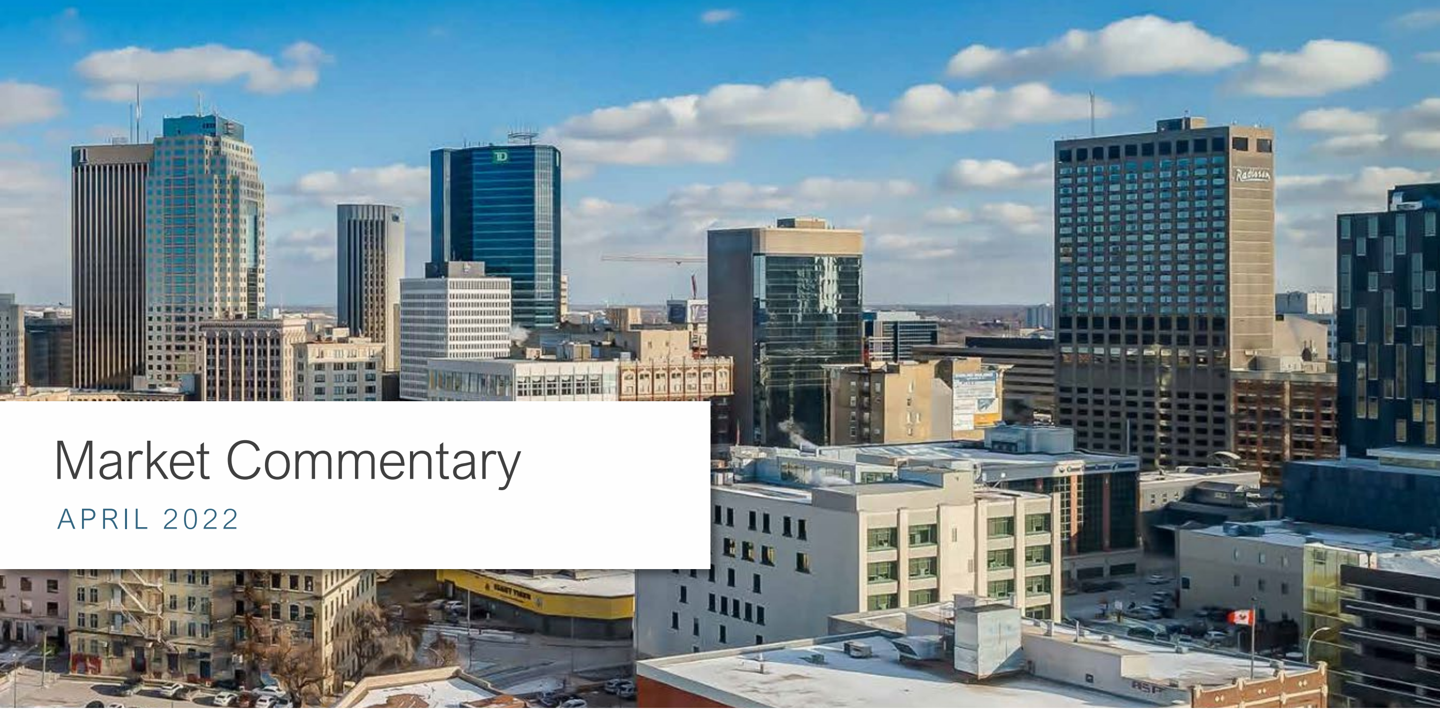


Market Commentary

APRIL 2022

Private Real Estate, Rising Interest Rates, High Inflation and Supply-Demand Dynamics

The rising interest rate, high inflation environment we find ourselves in today is not unprecedented. Although the narrative around rising interest rates and real estate investments is mostly negative, research suggests the opposite is true.

A recent article[1] by NAREIT shows that public REITs often outperform the broad stock market (as represented by the S&P 500) during periods of rising interest rates. Furthermore, it is argued that such players are better prepared to weather interest rate shocks than they have been in the past, with strong equity issuance, declining leverage, high interest coverage ratios and longer debt maturities than in the past.

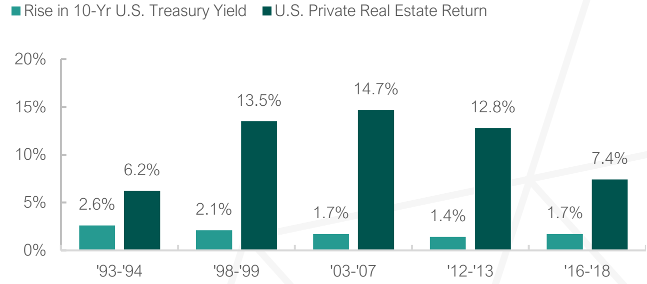
Can these conclusions be extended to private real estate? Research from Blackstone[2] and Franklin Templeton[3] shows that not only do private real estate values generally increase during periods of rising interest rates, but that they do so with less volatility than public REITs and with a higher average annual yield. Not only that, but privately-owned real estate offers durable income streams with attractive yields and a hedge for inflation, as income streams rise with inflation due to the short-term nature of leases. Research from GWL Realty Advisors[4] extends this analysis to the Canadian markets and finds similar dynamics.

Adding to the asset classes' historical outperformance is the structural supply and demand imbalance in the current environment. Recent research[5] from Scotiabank estimates a large gap between the number of dwellings per capita in Canada versus other G7 countries (425 dwellings per 1,000 individuals in Canada versus 480 dwellings per 1,000 individuals G7 average). Two of the three Canadian markets Avenue Living operates in are below the national average of dwellings per capita, according to Scotiabank's research.

In the most recent federal budget, the Canadian government estimates the structural housing shortage to persist, as national programs have historically not been enough to suppress it. It follows that real estate asset appreciation should continue if this imbalance persists.

While we may have suggested a less abrasive headline, BNN Bloomberg has also recently contributed[6] to the topic of REITs as a potential opportunity for investors looking for exposure to alternatives.

Exhibit 1: U.S. Private Real Estate values generally have increased during periods of rising interest rates



Source: Blackstone Real Estate Trust

A Cap on Cap Rates

Cap rates are calculated by dividing a property's net operating income by its price. In a rising interest rate environment, it is widely expected that this rate will also increase, but does it?

NMHC has published a note[7] exploring the relationship between interest and cap rates. What it has found is that the relationship between nominal interest rates and cap rates is weak, with periods in which interest rate increases were followed by decreases in the cap rate. How can that be?

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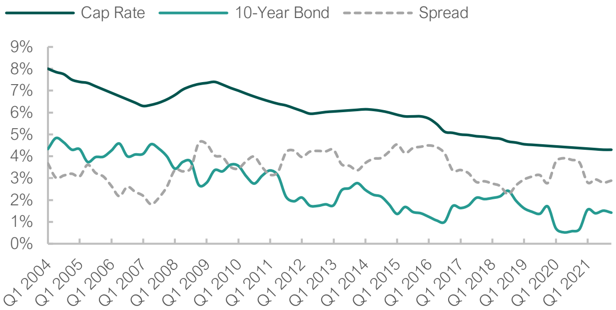
Cap rates may be interpreted as the real estate investor's weighted average cost of capital (WACC) minus growth (WACC - g). As the WACC increases with interest rates (driven primarily by an increase in the cost of debt), growth will also increase (driven by increases in rents and property values). Therefore, cap rates may stay flat or even fluctuate lower (if the cost of debt increases by less than the increase in g). Why would this dynamic be in play?

Exhibit 2: Cap Rates vs Canadian 10-Year Bond Yields



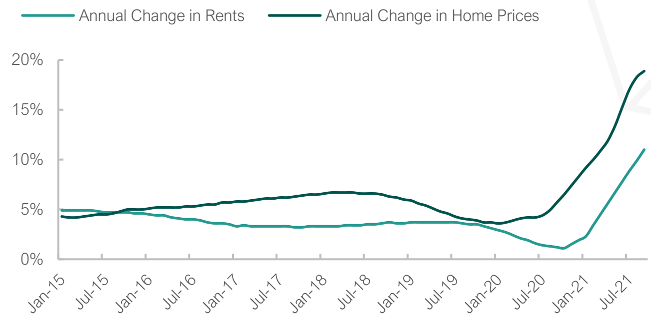
Source: GWL Realty Advisors

As mentioned previously, rents will rise in inflationary environments, due, in part, to the short-term nature of leases. Therefore, increased costs driven by higher interest rates or inflationary pressures can, and are, passed through to the renters. Real estate assets are famously seen as a hedge to inflation and, as such, their prices also increase in inflationary environments. As seen in this Joint Center for Housing Studies of Harvard University article[8], house prices may increase even faster than rents. Similarly, the replacement cost of real estate assets increases with inflation (or more), driving up rentals of new stock. The increase in rents observed in the market pressures rentals of existing stock higher, as well.

Similarly, when real estate values increase at a faster rate than the income derived from such assets, we will see a compression in cap rates. If interest rates are rising concurrently, as they normally do during inflationary environments, we will see a decrease in the spread between interest rates and cap rates. To add to the cap rate compression, home prices accelerating faster than rents will decrease homeownership affordability and drive more individuals towards rentals, thus supporting rental rates.

Supply and demand dynamics play a key role in the determination of cap rates. The cap rate can be thought of as the "interest rate" at which the housing market clears – where supply and demand balance for a given market. A structurally undersupplied housing market, such as the one we have in Canada and the U.S.A., will lead to natural upside limits to cap rates as demand will outstrip supply. When do cap rates increase? In markets where affordability is a current issue, cap rates are likely to go up, independent of the move in interest rates. Similarly, if the prospect for growth within a market is revised down, this will put additional upward pressure on cap rates.

Exhibit 3: Rents Are Rising, But Home Prices are Rising Faster



Source: Joint Center for Housing Studies of Harvard University (JCHS)

NOTES & CITATIONS

(1) NAREIT, 2018. REIT Stock Performance and the Interest Rate Environment. (2) Blackstone Real Estate Trust (BREIT), 2022. Why Private Real Estate. (3) Franklin Templeton Clarion Partners, 2021. Optimistic Outlook Amidst Rising Inflation. (4) GWL Realty Advisors, 2022. On the Rise: A Closer Look at Inflation and Canadian Real Estate Implications. (5) Scotiabank, 2022. Which Province Has the Largest Structural Housing Deficit? (6) Business News Network (BNN), 2022. If buying a home seems impossible, REITs could be the next best thing. (7) National Multifamily Housing Council (NMHC), 2022. What Rising Interest Rates Mean for Apartment Cap Rates. (8) Joint Center for Housing Studies of Harvard University (JCHS), 2022. Rents Have Soared Across the Country, but Home Prices Grew Even Faster.

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