AFTER UNDERPERFORMING IN 2023 – CAN REITS RALLY THIS YEAR?

Middlefield President outlines what the year might hold as real estate investors reassess hard-hit subsectors

Published Jan. 16, 2024

Real estate investment trusts (REITs) had a difficult 2023, at least when we take a macro view. These real estate assets struggled as dynamic post-pandemic Canadian and US economies made investors wary of certain subsectors. That story was most pronounced, and noisiest, in the office subsector. Narratives around office vacancy rates and the persistence of remote & hybrid work dragged on office performance. At the same time, rising interest rates pushed investors away from income-paying real estate investments like REITs in pursuit of higher yields from GICs and fixed income.

Those trends shifted around the end of October, however, as investors began to firm up their rate cut outlooks for 2024 and treasury yields began to drop. This year offers a potentially rosier outlook, according to Dean Orrico President and CEO of Middlefield. Orrico highlighted the positive impact of predicted future rate cuts, the declining income yields we're already seeing in fixed income, and the real positive tailwinds in many subsectors outside of office REITs as reasons for a better year.

"As we go into 2024 our view is that rates have plateaued and are likely going lower. It depends on your personal perspective but you're going to see rate cuts this year, you'll see as few as two and as many as five or six. It's likely somewhere in between," Orrico says. "With the short-end of the curve coming down by at least 50 basis points and maybe as much as 150 basis points, with the long-tend staying flat at least and probably drifting lower, the outlook is certainly a lot better as you go into 2024."

The narrative predicted a slowdown and rate cuts in 2024 has hit a few bumps so far this year.

Notably, US CPI data came in a little hotter than expected and Canadian jobs numbers and wage growth have been higher than expected. However, Orrico notes that investors have largely shrugged off those indicators and held to the consensus that the worst of inflation is behind us. Yields, Orrico notes, haven't risen materially as a result of those indicators. As those yields stay below their peaks and drop further as rate cuts are realized, Orrico believes that the cash sitting in fixed income is likely to rotate back into REITs as investors seek higher-yielding income opportunities again.

The overall performance of REITs in 2024 may well be set by the opportunities and challenges faced by REIT subsectors. Office REITs, Orrico says, may remain challenged on the whole, but there are glimmers of opportunities in specific assets. Newer office buildings with more amenities, better airflow, and light are performing quite well according to Orrico. These building types have 90 per cent plus occupancy rates.

The challenges in the office space are in buildings that are decades old, lack nearby amenities, and face issues with their air quality and access to natural light. Those buildings, Orrico says, will either be repurposed, renovated, or turned into a higher value use like housing. Orrico notes, however, that the inherently slow-moving nature of real estate development makes those transitions gradual. In the meantime, we may still see the office subsector challenged.

While office real estate may drag, industrial real estate has been a leading light for investors. In the GTA in particular we see one of the fastest growing industrial real estate markets in North America. Rents in the past decade have risen from $5 per square foot to over $20. Orrico expects some of that rent growth to plateau in future, but argues that there is still significant earnings growth to be had in industrial real estate.

Rental apartments are also an attractive opportunity, given the scale of the housing shortage in Canada right now. There's a real lack of new supply, especially as higher interest rates pushed back development projects. At the same time, Canada has increased immigration rates significantly and shows no signs of meaningfully slowing down. Rents are being driven higher and apartment REITs are the beneficiaries.

Two areas that had struggled during the pandemic but are now showing more attractive tailwinds are retail and senior housing. Grocery-anchored retail, essentially strip malls and plazas, is of particular interest to Orrico. He notes that these plazas have continued to do very well especially as development has slowed significantly. Senior housing also offers very attractive tailwinds as managers move on from pandemic-related costs and continue to pick up demand from an aging Canadian population.

While these strategies aren't as available among Canadian REITs, Orrico sees opportunity in data centre and cell tower REITs in the United States. The portfolios managed by Middlefield, he says, try to balance some exposure to these US strategies along with Canadian REITs in what Orrico calls a "high conviction" focus on 30-35 names per portfolio.

As advisors look at their clients' income strategies and real estate exposure in 2024, Orrico believes they should be looking closely at the potential for REITs, with the addendum that not all REITs are created equal.

"It's not homogeneous. What's happening in office is very different than what's happening in retail, very different than what's happening in senior housing, very different than what's happening in industrial," Orrico says. "You need to approach it from a diversified standpoint, you need diversification and you need active Management."

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