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Investing in Post-Pandemic Real Estate

Why 1832 Asset Management's Tom Dicker sees some promising pockets in certain commercial realty and single family homes

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The impact of the economic lockdown from the pandemic has been devastating within parts of the real estate sector, especially in commercial realty as countless businesses leave or are unable to pay their rent, and workers are encouraged to work from home leaving their offices empty. Yet Tom Dicker, co-manager of the 5-star rated $200.3 million Dynamic Global Real Estate Fund Series F argues that all is not lost and certain sub-sectors have survived if not flourished recently.

"The investable REIT [real estate investment trust] universe has changed meaningfully such that when people think about what constitutes commercial real estate, they often think about an office building or a retail shopping centre. That is not necessarily all that the investable public real estate universe is about," says Dicker, vice-president at Toronto-based 1832 Asset Management LP. "There will be lots of challenges in those traditional asset classes, such as offices, retail and hotels, which are likely to get worse before they get better. But there are lots of areas where we believe there will be positive outcomes, even as a result of the economic disruption. And there will be areas where it will be neutral, or slightly negative."

Real Estate for Post-COVID Reality

Areas that will benefit include data centres and cellular phone towers, which have only been regarded as investable assets for the last two decades, says Dicker, who shares duties with portfolio manager Maria Benavente and senior vice-president Oscar Belaiche, who oversees the equity income group. As well, logistics and warehouse space will also benefit, thanks to the significant acceleration in online shopping. "Demand in that area continues to grow and will likely to outpace economic growth for the next decade. That's our base case now," says Dicker, a native of Renfrew, ON, who joined 1832 Asset Management in 2011 after he worked for investment counsellor LDIC Inc., and earned a bachelor of commerce degree from the University of Ottawa in 2004.

Areas such as the laboratory-office space should also grow, as healthcare will attract more funding and the area relies on sophisticated airflow systems. "The next decade was going to be about healthcare, because of the ageing population and the advancements in healthcare."

Another promising area is the single-family home rental. "If you had a choice between renting a home and renting an apartment, in a lockdown scenario or maybe you want a home office, you'd grab the home. That market is extremely strong. So there have been some areas where it is not a depression." Self-storage and manufactured housing should also escape the impact of the pandemic.

Arguing that the market has presented a mixed picture, Dicker acknowledges that he and co-manager Maria Benavente have made some portfolio adjustments. "We were already fairly well-positioned for this [market correction] and not because we thought there would be a pandemic. We were positioned in property types in which we believe there are good long-term secular trends. Some of those trends include digitization and the move to more data and renting versus owning single-family homes and shopping online. Those are long-term trends."

Crisis Gave Tech a Boost

Moreover, the pandemic only produced a "huge" acceleration of long-term trends, says Dicker. "We heard Satya Nadella, the head of Microsoft, say that 'we saw two years of digital transformation take place in a couple of months.' Some of the trends, that we were positioned for in the long run, accelerated very quickly. That explains why we've been ahead of the peer group."

Year-to-date (as of July 20), the fund returned -7.96%, compared to -14.17% for the Real Estate Equity category. Over the longer-term, the fund has also outperformed. It averaged 5.28% and 9.68% for the past five 10 years, respectively. In contrast the peer group averaged 2.89% and 8.02%.

What lies ahead for real estate is very difficult to predict, although there is a wide range of possible outcomes. Much depends on each particular sub-sector and how the virus plays out. "If we see this surge in cases in the U.S. Sun Belt get worse, and we see the prospect of further lockdowns because the capacity of the healthcare system has been breached, that will be bad for those cyclical areas such as retail and hotels that have already been hit fairly hard," says Dicker. "There will be more bankruptcies in the hotel sector and among retail tenants and landlords. It will drive up the cost of funds meaningfully. You want to be really careful in the cyclical or value areas."

A great deal also depends on policy responses to the pandemic and the development of a vaccine. "If the market believes there is a highly effective vaccine that comes in the fourth quarter or the first quarter of 2021, it will get very excited and start to price in a return to normal," says Dicker. "Lenders will be much more lenient. There is a scenario where if there are treatments and vaccines, the market will look through that. But if it looks as if this will go on for a while, and with the caseload where it is [in the U.S.] there is still some downside in lots of these stocks."

Dance Between Defensive and Offensive

From a strategic viewpoint, Dicker says he's taken an approach balanced between defensive and offensive positions. "We own some areas where if the economy does better those areas could do well, but are still reasonably defensive. These are areas such as industrial real estate, which has a big tailwind from e-commerce that we believe will drive returns." Within residential stocks, for example, Dicker is skewing the portfolio toward more defensive names with high-quality balance sheets and low risk of poor outcomes.

When the market corrected in March, Dicker and Benavente lowered the cash from 9% to about 4%, and added to some of the top holdings in the 49-name portfolio as well as did some repositioning. The managers reduced retail allocation and focused on grocery-anchored shopping centres. At the same time, they added to logistic names, data centres and specialized REITs, where the sustainability of distributions is superior to those areas that have been hit. Within the office sub-sector, they chose to be more defensive and reduced traditional office concepts that will be in a more challenging environment in the future.

From a geographic standpoint, about 44% of the portfolio is held in U.S. stocks, 35% Canada, 5% the U.K. and 4% Australia. On a sector basis, residential is the largest area at 33%, followed by 23% industrial, 17% specialized REITs and 8% offices.

One of the top holdings is Goodman Group (GMG), an Australian real estate developer and asset manager with global operations and an emphasis on logistics and warehousing. "We are really bullish on the logistics and industrial space, given the acceleration we have seen in the area. The e-commerce theme will continue to grow," says Benavente. "For instance, e-commerce in the U.S. increased to 20% of total sales in May, from 15% prior to the pandemic. We expect that to be maintained and further accelerate. One recent estimate says that e-commerce as a percentage of retail sales will grow to 30% over the next five years. This will drive demand for logistics real estate that is very important for the infrastructure and delivery of goods to people."

The stock, which has a 2% distribution yield, is trading at 25 times forward price to adjusted funds from operations, which is lower than a comparable company such as US-based Prologis Inc. (PLD) There is no target for the stock.

Another favourite is Tricon Residential Inc. (TCN), a Canadian-based REIT which owns and manages properties mostly in the U.S. "Over the last decade, they have been a big consolidator in the single-family home rental asset class," says Benavente, adding that Tricon has grown into one of the most sophisticated platforms for single-family rentals and has one of the largest portfolios. "It's been a success story and one that has been very resilient in spite of the challenging times."

The stock, which trades at a 25% discount to net asset value, pays a 3.1% distribution yield.

Despite the uncertainty in the economy, Dicker believes that the companies in the portfolio are well-positioned to weather the hard times. "Should the economy recover there is lots of room to run. We are well-positioned between offence and defence," says Dicker. "On top of that, we are in a very low yield environment, with 10-year Canadian government bonds yielding 52 basis points. Real estate is one of those areas where you can get a predictable stable yield. Office and retail real estate may not do well, but within other sub-sectors, there is lots of room for valuations to recover and expand even further."