

Real Estate Performance Post COVID-19 is All About Sector

Over the years that I've run Centurion, I have always been asked about what happens to the REIT when "the real estate market" goes down. The question in my mind has implied two misconceptions: one, that all real estate is homogenous and thus moves together; and two, that single-family home prices move with commercial property prices. My standard response has always been to clarify first that there is no such thing as "the real estate market" and then take the analysis of why this is so to a deeper level.

COVID-19 has demonstrated, in the most profound way, that the real estate market is not homogenous. It has always been a cliché that real estate was about "Location, Location, Location". Today, and for the foreseeable future, it is all about "Sector, Sector, Sector".

You can generalize the drivers of real estate value into three broad categories: common drivers, property-specific drivers, and industry-specific drivers. In this paper, I will focus on the industry-specific drivers of performance for the various sub sectors of real estate during COVID-19, and my view on how these sectors will likely perform going forward.

Common drivers are things like interest rates, inflation, and government policies (like taxes). Interest rates drive all asset values, not just real estate values. Given that real estate is a leveraged strategy, the cost of borrowing over time will affect valuations not only because of discounting of future cash flows inherent in valuing all investments, but also because leverage entails maturity and liquidity risk. Market disruptions to the availability of mortgage financing and the cost of this leverage can drive property values and sales, including through forced sales.

Property-specific drivers are more along the lines of the old cliché of "Location, Location, Location". Because property is immovable, is there demand for the property and is that demand going up or down? What is the supply and is it going up or down? I will not spend much time on property-specific and common drivers as these are not the primary drivers today of sub sector performance and the focus of this paper.

Over the years, I've spent so much time explaining that all real estate is not the same. That has now become obvious to almost everyone. Today, almost no one needs your hotel or resort property, your retail plaza, parking lots, office tower, or your Airbnb condo. At a time when food supplies have never been more of a concern, even some farms are having difficulty due to the logistics issues related to processing plant capacity, transportation, and shifting demand. Seniors housing will see years of hurt.

Even though my expertise is focused on multifamily, and some will wonder why I'm prognosticating about other sectors, I believe it is always important to understand the drivers of the various real estate sub sectors so that I can explain to investors why real estate isn't homogeneous and how to distinguish between them. Further, as a mortgage lender across numerous sectors, like we are via our Real Estate Opportunities Trust, you need to be informed of market movements and key drivers that may affect your investment performance. We also want to watch for opportunistic investments and severe market dislocations that can provide interesting strategic opportunities.

THE COVID-19 BACKDROP

This disease has impacted us in primarily two ways – health consequences and in our reaction to COVID-19. Our reaction to COVID-19 can be broadly broken further into the categories of policy response (regulations and business practices), fear, and forced adaptation. No prognostication of the future impacts of this disease would be complete, without some analysis of these factors.

It has become apparent that the health impacts of COVID-19 are minor for the vast majority of the population. It primarily impacts the very old and those with health problems (comorbidities in the current lingo). I will preface the following statistics by saying that I don't intend to be blasé and disregard that COVID-19 possesses risks, but we need some perspective on who is at risk so that governments can make informed policy decisions, individuals can decide how to live their lives, and as investors, how we think the world will evolve and position ourselves accordingly. I'm not a doctor, nor do I play one on TV, but I am required as a manager of people's money to consider how I believe the world will evolve and look to data to inform my decision making. Some summary data and discussion points that I think are important include:

- The median age of death of COVID-19 victims is 84 while the average life expectancy of a Canadian is 82.
- 82% of Canada's COVID-19 deaths have been in long-term care facilities.
- The average stay in a residential care facility is in the range of two years.
- 94% of hospitalized patients have a comorbidity and 88% have two.
- Young people without comorbidities have very little risk from the disease.
- The vast majority of people who get COVID-19 are asymptomatic.
- The CDC currently estimates the COVID-19 Infection Fatality Rate (IFR) at 0.26% in the range of the annual flu but this result is skewed heavily as most of the risks are to older and other at-risk groups and generally not the healthy young. As such, the risk for the young and otherwise healthy are even lower than this.
- We locked down early because: (1) we didn't know much about the disease at the time; (2) the death rates being reported at the time were very high (because the data was incomplete); and (3) we wanted to protect the capacity of the health care system to care for those that became ill.
- Our hospitals are presently not, or have they ever been, overwhelmed during the crisis.
- Suicide attempts are spiking dramatically. One hospital in California reports that they are seeing a twelve-fold increase in suicide attempts as people sink into despair.
- Many people are avoiding cancer diagnosis and treatment, having heart attacks and strokes, and not going to the hospital out of fear, and these are killing people too.
- There are two ways out of this crisis: (1) herd immunity or (2) a vaccine, which may take years or never come. Keep in mind, there has never been a vaccine for a coronavirus in history so we could wait in vain for years, destroy our economy through continued lockdowns, and lose many other lives through despair, suicide, abuse, missed cancer treatments, and other medical procedures, and revert to herd immunity being our only realistic option. In other words, we could lock down for years and it will all be for nothing.
- The politicians have so utterly failed to help us understand the difference between making the stay-at-home sacrifice of our fundamental freedoms and the economy to protect the capacity of the health care system and that if we lock down, we will be safe from getting COVID-19. They have given us no perspective and just sown terror among the population.

“Flattening the Curve” means we all get COVID-19, just not all at the same time, and that message has been lost. This disease is not like a burning ember which we can put out by starving it of oxygen. Until there is a vaccine, which may never come, there will be a reserve of it somewhere and it will persist, just like the flu and other diseases.

As such, I believe that we are long past the time to end the lockdown. Unfortunately, the fear that governments have sown will be hard to reverse and frankly, I cannot see them doing it. Too many would-be socialists have seized the reigns of power and made us completely dependent on them for survival. They will not release it easily or soon. A smart person can make a decision based on facts (at least what you think are the facts) then change your mind when the facts change and there is no shame in changing course now. Until the politicians are willing to de-escalate our fear, the economy and people will suffer.

Thinking this through, I revert to my earlier point that the effects are two-fold—health and our reaction. There will be short- and long-term consequences of these factors. In my opinion, health factors will predominantly impact the seniors sector, and fear and how we have changed will drive the other sectors. It is good news that because COVID-19 did not end up being as broadly fatal as feared and that in time, our fear levels will go down, life will return to some kind of normal for most people. Lockdowns may persist for some for a long time. Even then, some of them may want to make the choice for themselves whether they ever get to hug their grandchildren or are forever trapped in glass prisons. They should be allowed that choice.

Unfortunately, tremendous damage has been done. Many companies will not survive and many of the jobs lost will be gone for good. A recent survey of small businesses in the U.S. showed that nearly half expect that they will have to close permanently. In a normal recession, companies fail and new ones replace them in a recovery and many analysts believe this will happen now too. I remain unconvinced. The fear of a second wave, and another lockdown, will keep many would-be entrepreneurs unwilling to take the risk of complete ruination. So while I expect a bounce back in the economy and jobs, this recovery will be slower than historic ones.

For real estate, economic considerations aside, our behaviours have changed through forced adaptation. I have seen commentaries suggesting that once there is a vaccine or treatment, everything will be back to normal – with the implication that all sectors of real estate will be back to normal. I firmly believe that would not be the case because some of our behaviours have changed, because we were forced to change, and because our eyes are now open to possibilities, which were not apparent or that we were afraid to try before, thus upending historic practices. This is a theme I explore throughout this paper.

Hotels and Resorts

Always the riskiest of real estate sectors, this industry has never seen a crisis like today. Many require high occupancy rates just to break even, where today occupancy on many is in the 5-10% range if they are open at all. Mortgage financing is next to impossible today and this sector will likely be battered for years as the lockdown has damaged discretionary spending.

Additionally, high-density hotels are unattractive right now and destination vacations, where people need to fly in, will suffer for years. Interestingly, vacation bookings in some southern U.S. states have started to pick up as people from locked down states look for places within the country where they can drive to and that are not locked down.

Hotels also need the business travel crowd in urban centres to succeed. As social creatures, nothing beats an in-person meeting to build trust and “close the deal”. I did precisely zero video conferences

in the year before COVID-19. There was little need or expectation of such. We either used the phone or it was an in-person meeting. Now everyone wants to Zoom meet. I hate Zoom meetings because if I have to work from home, at least I want to be able to stay in my PJs.

While in person meetings will pick up, and so will business travel, we need to ask ourselves if our expectations to meet have changed and I would argue that they have. For me to fly to Vancouver, as much as I like it there, for two or three meetings, still kills two days of time and costs a lot of money in flights, hotels, restaurants, and other opportunity costs. People have become so used to Zoom calls and recognized the huge time and money savings that are possible. More than anything, expectations have changed, likely for the long term.

We will travel less for business; save the time and money and still get business done. It wasn't that we could not do this before, only that it was expected that you go in person and we will now do it less often, even with a cure. COVID-19 forced us and allowed us to change a business process that could have changed before. This is a paradigm shift. Overall, things will be bleak for years. I expect hotel rates to decline, occupancy to decline, capitalization rates to go up, and values to get hit hard.

Retail

For years, retail has been in decline with the assault of online platforms, like Amazon, stealing business. Many retail stores were going bankrupt even pre COVID-19. That trend has accelerated during COVID-19 and even with a full reopening, the prospects for retail are poor. What was considered one of the potential saviours of retail real estate pre COVID-19 was to reinvent them into experiential destinations with amenities like restaurants, gyms, coffee shops, and theatres. You can't "curb side pickup" your gym workout or your movie, and take out food is a pale comparison to the quality and service of the dine-in experience. If social distancing continues, experiential retail will have a very hard time, but there are worse things than social distancing, like Amazon.

Online shopping has bled sales away from traditional retail for years, but COVID-19 accelerated the trend. Because the lockdown has lasted as long as it has, many more people than before will have shifted a greater portion of their buying online permanently. The best hope for retail will be residential conversions and intensifications, which has been the trend for years. Almost every major retail landlord in the past few years has been trying to add apartments to their sites to diversify their income streams.

At most retail plazas, landlords are collecting much less than half of the rents. Many tenants will not survive. How does a restaurant that needs 70% occupancy just to break even survive if occupancy has to be limited to 25 to 50% due to social distancing by-law or because of customer fear? Yes, governments designed programs to lend to companies to bridge them until better times, but many will find it very unattractive to stack on debt month after month, with no assurance of survival.

John Tory, mayor of Toronto, announced on May 29th that major banks and firms were asked not to return to their downtown towers until at least September. I've been told that bank employees are being whisper-advised that there will be no return until at least January. For the 1,200 shops and services in the 30-kilometer PATH, Toronto's underground complex, that will mean near certain death with few of the regular 200,000 commuters that regularly used it before for a period of almost ten months. The many other businesses that rely on the downtown business and commuter crowd face a similar fate.

In normal recessions, new tenants would replace businesses that failed eventually. As a health event, COVID-19 could hammer the ability for new retail businesses to even start, let alone survive. Some

will, of course, but until social distancing, whether by law or fear, is no longer a factor, retail as a sub sector, will struggle. Even with a vaccine or cure, retail will have serious problems.

I have heard numerous retail landlords talk about retail about being more than shopping. It is an experience and as such, once the health crisis is over through a vaccine or a cure, retail returns to normal. I'm not so optimistic. Retail was on the decline before, and this just reinforces and accelerates a trend of decline that was already in place. I expect an acceleration of the trend of residential intensification/conversion. I expect rents to go down, capitalization rates to go up, and values to go down.

Student Housing

Student housing has always been perceived as a recession-resistant sector; as when the economy is bad, students tend to stay longer at school to await a better employment market. Over the years I've always been asked what impact online learning would have on student housing, as the assumption implicit in the question has been that because it was cheaper, education would transition to online and reduce the demand for student housing materially.

COVID-19 resulted in the largest test of online learning in history and the results are in. It was a dramatic failure. Students hated it. The experience does not line up with the cost. There are significant accessibility concerns. Something in the order of 50% of students do not have an adequate place in their homes to study remotely (think shared bedrooms with younger siblings or lack of a quiet place to listen to a class or study). Something in the order of 25% of students do not have fast or reliable enough internet to study from home (think non-primary cities and first nations communities), which raises significant access and inequality issues.

You cannot replicate the in-person work online and the social experience cannot be compared. Going away to school is more than about school. It is part of learning to be an adult, being apart from your parents for the first time, and learning key skills in managing your time, finances, personal relationships, feeding yourself, and life skill engagements like searching for and renting your first apartment.

Classes may be disrupted in the short term and occupancy may also suffer in the short term, but the opposite may be true. Given that on-campus residences are usually based on having two students per room, social distancing may mean that universities have dramatic shortages of residence beds, or no beds at all, in residences where whole floors share a common bathroom, forcing students into the off-campus community.

International student demand may decline in the short term, due to either travel restrictions or some will refuse to pay full prices for a reduced experience. These disruptions will likely prove temporary, particularly given that this young demographic has very limited risk to COVID-19. I do expect that in the short term, vacancies could be, but may not necessarily be, higher than normal until campuses open more fully and international students that aren't already here, come back.

Centurion was an early buyer in this space, but we have not bought more in years as some other firms were willing to pay what we considered excessive prices for assets. We anticipate that there will be opportunities for us to pick up some properties from over leveraged or poorly capitalized groups in the months ahead.

Rents in the short term may soften due to the need to complete fast lease ups that would normally have six to nine months of lead time when universities resume in person classes. Fortunately, with short leases (because students graduate eventually), rents can return to normal in the next leasing cycle.

Groups without deep equity capital and liquidity will likely see mortgage availability challenges. Centurion has recently completed two student property refinancing with rates at or below what would have been available pre COVID-19. I expect capitalization rates to go up enough for the returns to be attractive to us again. We are eagerly looking for opportunities.

I think the following cover of New York magazine says it all, about why university education will not be delivered online for the long term.

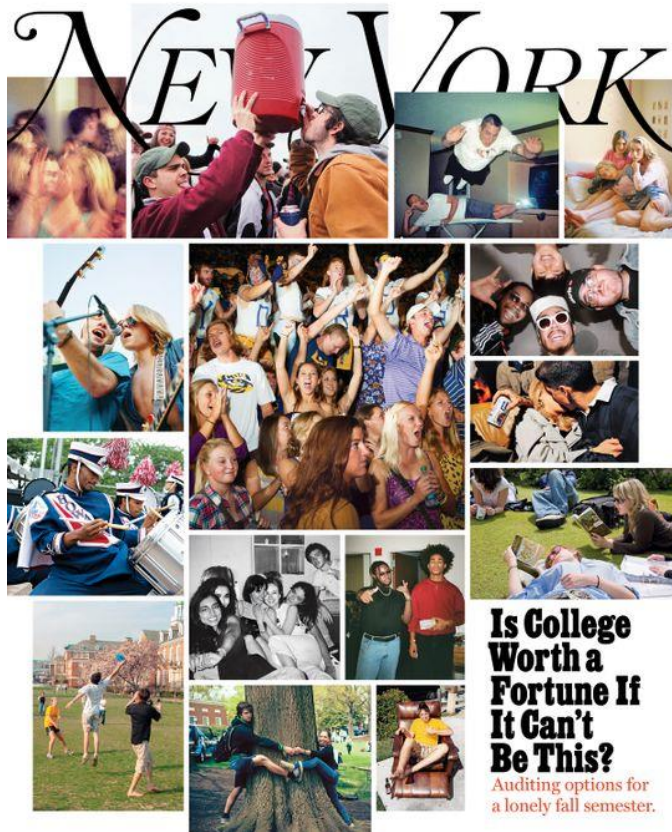


Image credit: New York magazine. May 11, 2020

Seniors Facilities

The seniors facilities sector will face a storm of problems and this industry will never be the same. With the vast majority of COVID-19 deaths being in seniors facilities, these facilities have significant problems attracting residents, as they will be seen as an absolute “last resort” for those without options. Families that were unable to see or assist parents and grandparents in lockdown, will look at moving family members back home, if at all possible.

Some operators and the government failed dramatically to protect the most vulnerable. In some U.S. states, seniors facilities were unbelievably required by law to accept infected patients and this resulted in their horrific death toll. Reports in Ontario were recently released showing how bad things were managed in numerous facilities. You can already see governments pointing blame on the operators.

There is blame to go all around, not just on the operators. Without doubt, no sector of real estate is going to get hammered with more regulations, extra operating costs, reputational damage, legal

liability costs, and reduced desirability and demand from residents and investors alike, than seniors facilities.

Long-term care, pre COVID-19, already faced headwinds from emerging technologies and services allowing seniors to stay in their own homes longer. COVID-19 is a game changer for this sector. I expect rents to go down, vacancies to go up, expenses to rise materially, net operating income to decline materially, capitalization rates to go up materially, and values to drop more than any other sector, and the headwinds are permanent.

Corporate Offices

We've just had the largest experiment in work-from-home (WFH) ever conducted and for the most part, it worked. More and more companies are exploring permanent or flexible WFH for part or all staff, which may permanently reduce the demand for office space. While some have tried to make the argument that the counter-balance may be that companies will opt for more space to de-densify their offices, thereby reversing the trend towards employee densification that has been playing out for years—I find that a spurious argument.

Aside from the fact that many businesses will not survive the shutdown and thus increasing vacancy already, flexible work is going to drive demand down even further. While I agree that we will still need office space for its social and collaboration benefits, I believe that office space demand will take a permanent hit.

I have heard about many office building plans for return to work. I know some office buildings plan to limit elevator occupancy to two persons, each required to face the wall during the ride. There is a discussion that tenants will have to use apps to schedule their arrival and departure times. This will be a disaster. Elevator cars designed to take 12-15 people up a 40-storey tower, can't just take two people and do 6-8 trips. The delays will be ludicrous, meaning no one will want to return to work until these measures are no longer required.

Elevators are closed boxes and all the germs that people spew will remain after they've left anyway, making this whole idea that putting hundreds of people in two at a time to meet "social distancing" requirements, whether legal or fear-based, will actually do anything other than virtue signal and provide a false sense of security. Will you wait for an hour to go up and an hour to go down? That will mean a two-and-a-half-hour lunch break (one hour down, half an hour eating and an hour back up). What about a fire? How do we "socially distance" and evacuate a tower? It is lunacy. Eventually, it will be seen as completely unworkable and ineffective and will be abandoned. I'm frankly surprised that this is still even being talked about because it is so silly.

The climb out of this recession will be a long one for offices. Yes, social distancing will end some day with herd immunity or a vaccine, but the damage will be done. We will have become so used to working remotely, and companies will now see that it works and be happy to embrace cost savings.

In our own case, we were looking for more office space pre COVID-19. We did not allow WFH, fearing the loss of productivity and collaboration. We have surveyed our workforce about returning and about other aspects of the pandemic, including how well they work from home, and whether they want or would use a permanent flexible work program. These are the results:

- 99% felt they had everything they need to perform their roles while working from home.
- 97.6% reported they were as productive (62.2%) or more productive (35.4%) as before.
- 96.4% believed they had the necessary technology to remain connected to their team members.

- 84% preferred to continue to work from home if it is an option.
- 99% found it valuable to them to have a permanent post COVID-19 WFH program.
- 73% would work from home between 25% and 75% of the time.

I don't think our company will be unique in these findings. COVID-19 forced on employers and employees a program which most employers were fearful to even experiment with, let alone embrace. Now that we see that it can work, and that people want it, will force a paradigm shift. Employees will expect flexible work arrangements post COVID-19 and will go to companies that can offer it. Employers, no longer fearful of it, will offer flexible work to attract and retain talent and to save money on office space.

In our case, I believe our office capacity post COVID-19, with a flexible work program in place, could rise 30-50%. That is a lot of money saved in rent. While it is true that people long to get out of their house and go to work and see their colleagues because work is more than just work, that does not mean that we need as much office space as we thought before.

The office sector will face the loss of tenants that go bust, a slower than normal recovery of the economy which impacts demand, reduced demand because who wants to wait two hours a day for elevators while those rules last, and also that the whole nature of what we thought work could be and how much office space we need as a result. The headwinds are long-term and my conclusion is that vacancies will go up, rents will go down, capitalization rates will rise, and values will drop.

Medical Offices

Coming out of a health crisis, I believe that medical offices will be an exception to the head winds in the office space. The need for doctors has not gone away. If anything, our doctors, many of whom who have had to work from home as "discretionary" procedures were delayed, will see the fastest return to being fully busy. They will have long lines to catch up.

There are some distinct locational and clustering benefits of dedicated medical offices that make it more resilient than standard offices. It is possible though that some doctors that do not need to be close to a hospital could be tempted into cheaper conventional office space, but this isn't too likely as most doctor's space is small, so the savings would likely be marginal and they tend to be resistant to moving away from where their current patient roster visits them.

Patients, like doctors, also prefer dedicated facilities where they can see their specialist referrals or have tests done. Virtual care (i.e., remote work) is possible but not for everything; so even though some doctors will come into their offices less, they will still need offices to actually meet with patients that need to be seen. This will really improve the patient experience long term. Instead of driving to and from the doctor's office and then waiting forever for your turn, you will now be able to connect online for many things. This is great for patients and doctors.

I expect rents to remain intact and capitalization rates to remain unchanged or decline marginally as investors put increasing focus on economically resilient property types.

Condos, Houses, and Airbnb

It has always been the case that the housing market has been what most people mean when they talk about "the real estate market" and assume that what happens to housing is happening to all sectors of real estate. Further, there is the impression that what is happening in Montreal, Toronto, and Vancouver (MTV) is a representative of what's happening everywhere. The media often makes these

mistakes and reinforces these misconceptions in ignoring property-specific and industry drivers, and only paying attention to common drivers.

In my paper “Outlook for the Canadian Multifamily Industry Post COVID-19” (published April 27, 2020), I projected that downtown core rentals would get hit due to Airbnb. Not only are these units no longer rentable as hotel alternatives due to the recent ban on this usage, COVID-19 hit almost simultaneously, depriving many of these owners of rental income to service their debts. Without the deep and sophisticated rental operations infrastructure of a professional apartment company, many of these small owners, as I expected, took significant rental rate discounts to get some cash flow. These high rental rates historically drove up returns and thus prices; so as the market opens, softness in core condo prices will likely follow.

Purpose-built apartment rental rates, in comparison, do not seem to have been as affected. In our own portfolio, we have not seen rental rate declines, but we do benefit from being in the suburbs and exurbs, which did not have Airbnb and where demand to live is also continuing to shift – a trend we have talked about for years due to affordability. For an apartment building with 100 units, a vacant apartment or two is normal course and built into your budget. For an Airbnb owner that has one unit, a vacancy means 100% income loss, but no reductions in overheads (insurance, property taxes, maintenance costs). Faced with no dedicated leasing infrastructure, competition, and expenses to pay, they panic and discount their rental units.

In my discussions with numerous developers, I have been told that condo unit sales in the core are negligible now. However, sales of lower-cost, low-density housing like townhouses or stacked townhouses in the suburbs have been extremely brisk. Some have described the buying as “panicked”. Why the divergence?

As the pictures from Trinity Bellwoods Park have shown us, people are desperate to get outdoors. These young people have been locked down in their tiny apartments and condos for almost three months. Their gyms, common areas of their buildings, clubs, and restaurants are closed. They have no place else to go. Frankly, I was amazed at the outrage, notably from people who live in the suburbs and have backyards or live in low-density neighbourhoods where there is somewhere, anywhere to go. If they do not live in a shoebox, maybe these Karens need to walk a mile in someone else’s shoes.

A number of large high-rise condominiums are also enforcing two person limits in elevators, meaning that it can take 40-60 minutes to get in and out of the building, unless you can walk the stairs. If you have a pet that needs to be walked three or more times per day, that is 4.5-6 hours just to get in and out for the dog, let alone to do anything else. This is completely unsustainable. People are reacting with their feet and looking in the suburbs. If these rules are not relaxed soon, tensions will boil over, and condo rents and prices will collapse. These are very unattractive places to live with those restrictions, in tiny places, at those prices, with no access to amenities or places to go. So, the demand has shifted and people are looking at the affordable suburbs, where density is lower, units are larger, and prices cheaper.

This is a trend I have discussed many times over the years—that rents outside the core were very cheap relatively speaking and affordability got to a point where people needed to decamp to where they could afford. This is why we focused on the suburbs and exurbs. We believed that properties were cheap on a relative basis. We believe that the trends, which have driven the success of our strategy in pursuing non-downtown core apartments, remain intact and have further momentum behind them post COVID-19 as people seek the space opportunities, both in terms of larger unit sizes common outside the core and also in terms of lower density of people, making it easier to socially distance with less effort and get outdoors.

Further, as work from home becomes much more common, more people will be able to move to the suburbs for these benefits. Besides, outside of long-term care facilities, much of the COVID-19 problem was concentrated in the dense cores, not in the suburbs/exurbs. Centurion does not have core Toronto or Vancouver rental units so we have not seen these rental rate declines, but poorly researched articles in the media continue to suggest that what is happening in core MTM represents all of Canada; it never has and doesn't now.

On June 4th, CMHC announced that it is tightening its underwriting for insured mortgages with new rules effective July 1st. The new rules increase the credit score requirements of borrowers materially from 600 to 680, limit the Gross/Total Debt Service ratios to 35/42, and limit certain sources of down payments as being treated towards equity. This tightening will restrict both the number of buyers in the market and the amount of house that they can afford. While I'm generally in favour of tight mortgage restrictions to protect taxpayers, doing so right now, when the market is already under strain, is a surprising move as generally market tightenings are done when the market is strong and not at times like these. Like prior market mortgage market restrictions, this has tended to force more people towards rentals or staying in the rental market and we expect this to be the same this time.

Overall, I believe that the loss of jobs (some of which will be permanent), high leverage levels of Canadians, slow economy (burdened as well by debt), the prospect of higher future taxes to pay for the costs of COVID-19, and the new tighter mortgage rules will reduce overall ownership demand and lead to a general softening of housing prices. As described above though, there will be pockets of strength in markets dominated by actual owners (suburban low density) and weakness in ones driven by investors and speculators, which are impacted by social distancing requirements making life very inconvenient (downtown core high density). This shift in the economy and debt aversion will drive demand to rental apartments as I discussed in my April 27th paper.

Industrial Real Estate

Some classes of industrial real estate have been exceptionally resilient. Logistics-related industrial has done well and should continue to perform in the new normal. With shopping shifting online even further than what was already the case, more inventory will be moving to logistics warehouses and these tenants had very low rental default rates during COVID-19. Small bay industrial, on the other hand, has performed less well as these tend to be occupied by smaller businesses, many of whom were disrupted during COVID-19. Many won't survive.

I believe that the performance of rents and capitalization rates will diverge depending on the type of industrial product with great performance in warehouse industrial and weaker performance in small bay industrial. That said, if I was looking for office space today, I would be looking for an industrial office with lots of space and no elevators. I have talked to many businesses that have these kinds of offices and they are open and functioning almost normally.

Farms

I have always been attracted to farms as an investment class. It is a core needs business just like apartments, which are our bread and butter. It provides good long-term returns and is an excellent inflation hedge. COVID-19, however, has disrupted the farming business as well in ways we wouldn't have thought of before.

Due to COVID-19 infections, food processing has been disrupted causing some livestock and crops to have to be destroyed. Further, demand has shifted with restaurants closed and people eating from home. So, while some farms are doing just fine, others are struggling because what you have already planted or raised just can't shift on a dime. There will be disruption, but hopefully, it's temporary.

Just like it is now apparent to everyone that relying on other countries for critical items like medicine, masks, ventilators, and more broadly, to be at risk for long supply chain items, it is also now apparent that we need to pay more attention to food security. Having three meat-packing plants processing 85% of our beef seems reckless in the extreme. Change for the better is coming. We may see some disruption to farmland assets, but I would see this as temporary and likely, an opportunity.

Apartments

I detailed my views on the apartment sector in my April 27th paper “Outlook for the Canadian Multifamily Industry Post COVID-19”. My views still stand and I would direct you there for my detailed walkthrough but will summarize my views here as follows:

Apartments proved themselves, again, to be the most resilient sub sector in real estate and one of the most resilient of all businesses during COVID-19. Looking forward, the tailwinds behind apartments will continue to be strong and broadly fall into these categories:

1. Strong immigration
2. Housing affordability limiting the ability to buy or qualify for loans to buy property
3. Millennial preferences
4. Aging society
5. Construction constraints on new housing
6. Desire to age in place and avoid seniors’ homes
7. Deleveraging/de risking and changing home ownership and investor intentions
8. Elimination of Airbnb as a force, in our major cities, will result in lower, long-term construction of condominiums, which have fed the shadow rental supply
9. Preference for multifamily apartment investments over other asset classes will increase

A WORD ON DEBT AND EQUITY CAPITAL AVAILABILITY

Capital availability, both debt and equity, is the lifeblood of real estate because it is a capital-intensive business. Real estate is a leveraged strategy, so reasonably priced mortgage debt is key to achieving good long-term returns. Mortgage availability is a risk factor in the real estate business because leverage introduces risks by accentuating losses in a downturn, and if your mortgage matures at a time when debt is expensive or unavailable, it could force a property owner into financial distress.

Apartments, along with seniors facilities (and sometimes student housing), have the unique benefit of having access to CMHC insured mortgage financing. This insurance means that a mortgage lender does not have risk if a mortgage defaults, making these attractive investments for banks, insurance companies, and pension funds even during a financial crisis. An investor with a CMHC-insured mortgage benefits by getting a lower cost mortgage than a conventional mortgage, and also because these are the most sought-after mortgages as access to a mortgage or a renewal upon maturity is nearly guaranteed.

CMHC insurance helps keep the supply and quality of the housing stock (most of which were built 50-60 years ago) intact in part by keeping lenders interested to provide capital to housing providers because it is a low-risk business and helps keep those housing providers financially stable, and continue to be able to meet their maintenance and capital re-investment requirements. As this insurance lowers the risk of owning apartments and other insurable classes, it encourages investment in housing whether new or existing stock.

Other real estate sectors that do not benefit from CMHC insurance can see access to debt and equity capital become strained, particularly during a crisis like COVID-19 or the Great Financial Crisis. Mortgage availability can become restricted, with leverage lowered, interest rates increased or be unavailable altogether.

The same can happen with equity capital. While mortgage markets continued to function for apartments (Centurion was recently able to finance 10-year fixed rate mortgages at 1.65%), other sectors saw severe disruptions to capital availability. The increased cost of debt, lower leverage, and reduced availability will increase the cost of equity for the affected sub sectors, squeezing returns, pressuring up capitalization rates, reducing values, reducing transaction volume/liquidity, and act as a further headwind to recovery.

It is my contention that not only will apartments continue to be the best performing sub sector in the months and years ahead, but that this superior performance during a crisis will cause a great rotation towards apartments by institutional investors, who are largely underweight the sector. It had been my view pre COVID-19 that the next decade would see the most investment in new apartments in two generations, to meet the nation’s growing housing needs (please refer to my April 27th paper “Outlook for the Canadian Multifamily Industry Post COVID-19” for details).

The case for apartments, as an asset class, has not only strengthened but become more obvious to everyone. For the reasons outlined in this paper, some of the capital that may have gone into the beaten down sectors (like retail and corporate offices) betting on a recovery won’t likely be there because the headwinds are from paradigm shifts, not just the usual and temporary recessionary factors. This is likely to make the headwinds to recovery of these sectors last much longer than normal and attract more capital than would otherwise be the case to sectors that show the most promise for returns and stability.

SUMMARY OUTLOOK BY SECTOR

Sector	Rents/NOI	Investment Desirability	Mortgage Availability	Headwind or Tailwind	Capitalization Rates	Values
Hotels and Resorts	Down	Down	Down	Headwinds	Up	Down
Retail	Down	Down	Down	Permanent headwind	Up	Down
Student Housing	Flat to Down	Down short term	Down CMHC possible	Temporary headwind Longer term tailwind with slow economy	Up	Down
Seniors Facilities	Down	Down	Down CMHC Available	Permanent headwind	Up	Down
Corporate Offices	Down	Down	Down	Permanent headwind	Up	Down
Medical Offices	Flat	Up	Similar	Tailwinds	Flat to down	Up
Condos	Flat to Down	Down	Down	Headwind	n/a	Flat to down

Sector	Rents/NOI	Investment Desirability	Mortgage Availability	Headwind or Tailwind	Capitalization Rates	Values
Houses	Mixed	Up relative to Condo	Down	Tailwinds	n/a	Mixed
Airbnb Units	Down	Down	Down	Permanent headwind	See comments	Down
Industrial	Mixed	Depends on sector	Mixed	Depends on unit type	Depends on sector	Depends on sector
Farms	Flat to down	Mixed short term, increased long term	Mixed	Mixed short term, tailwind long term	Flat to up short term, long term down	Flat to down short term, up long term
Apartments	Up	Up	Same CMHC Available	Tailwinds	Flat to down	Up

IMPLICATIONS FOR CENTURION'S PORTFOLIO

Centurion is in each of the businesses that it is for three basic reasons:

- Economic resiliency of the asset class
- Strong tailwinds that will support and increase values, providing attractive long-term returns with modest risk
- Personal interest, because I find things that interest me are fun, drive me to work hard, and I tend to excel when something is challenging and fun.

Our primary real estate businesses are apartments, student housing, mortgage lending (mostly in our core areas of interest), and more recently medical offices. Each of these businesses meet all of these requirements and I believe are positioned to prosper in the years ahead. While navigating through COVID-19 and its aftermath will no doubt be challenging, requiring us to think hard and adapt, I'm confident that we will see some exciting opportunities in the months and years ahead as a result.

Greg Romundt