North American Real Estate: Q1 2023 Update

March 28, 2023

Our View: Undervalued North American REITs offer opportunity amid market turmoil

In 2022, equity markets sold off significantly as central banks raised policy rates aggressively. The S&P 500 generated a -19.4% total return, comprised of +3.1% earnings per share growth which was completely offset by a -22.6% decline in the price-earnings multiple. Looking at US REITs, their trading multiple collapse was almost twice that of the market (-39.9%) despite their earnings growth being almost triple that of the market (+11.4%).

In Canada the story was much the same with the S&P/TSX down -8.7% as +11.1% EPS growth was offset by a -19.8% collapse in the trading multiple. Similarly, Canadian REITs generated positive +3.0% earnings growth but saw their multiples contract far more than the market as a whole at -23.5% **(Exhibit 1)**.

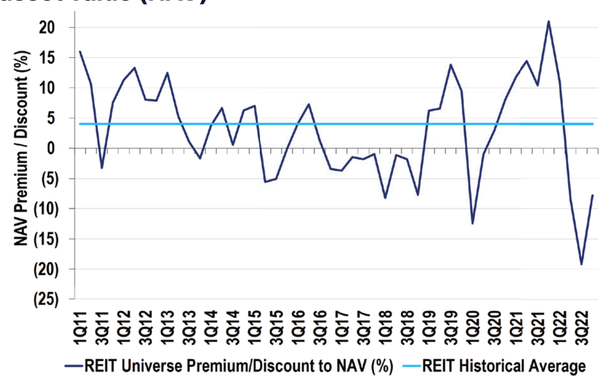
Exhibit 1 - S&P/TSX Composite

Index	Total Return	EPS Growth	PE Multiple
S&P/TSX Composite	(8.7%)	11.1%	(19.8%)
CDN REITs	(20.5%)	3.0%	(23.5%)
S&P 500	(19.4%)	3.1%	(22.6%)
US REITs	(28.4%)	11.4%	(39.9%)

Source: Piper Sandler, Bloomberg LLP, Starlight Capital
Notes: EPS for REIT sectors is Funds From Operations

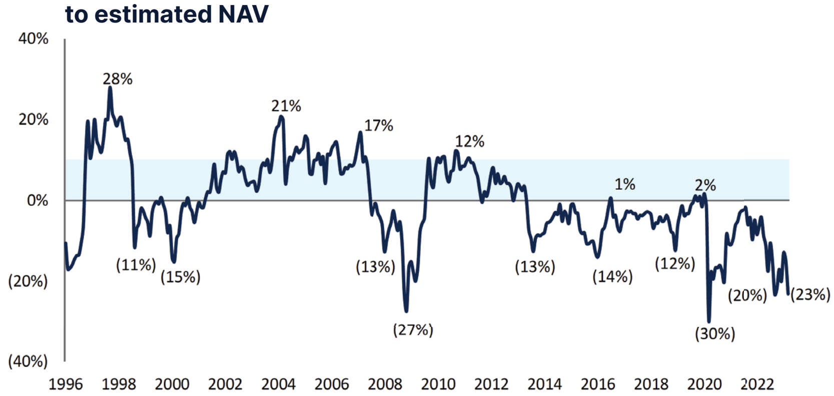
North American REITs were oversold at the end of 2022 and trading well below their Net Asset Value ("NAV"), even after adjusting for cap rate expansion. Currently US REITs trade at a -7.5% discount to their collective NAVs (long-term average of +5% premium) or an implied cap rate of 6.0% **(Exhibit 2)**. In Canada, REITs trade at a -23.0% discount to their collective NAVs (long-term average of 0% premium) or an implied cap rate of 6.0% **(Exhibit 3)**. Adjusting for their relative growth rates, North American REITs trade at very attractive risk-adjusted total return levels.

Exhibit 2 - History premium / discount to net asset value (NAV)



Source: Citi

Exhibit 3 - Canadian REIT sector premium / (discount) to estimated NAV



Source: RBC

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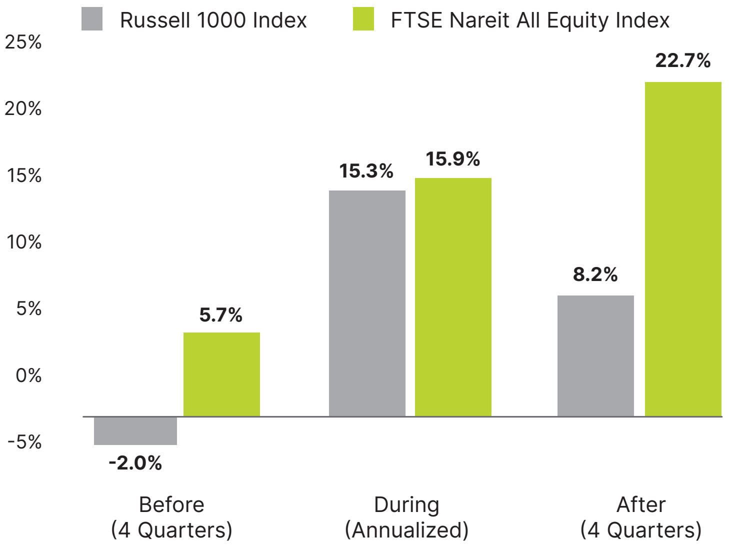
Skeptics will point to the potential for recession later in the year as a reason not to invest in REITs right now. We would point out that the extreme underperformance of REITs last year and their current discounted valuation is in keeping with the sector's historical performance prior to a recession and during a rate hike cycle. The Federal Reserve and the Bank of Canada have essentially completed their rate hike cycles and inflation in both countries has fallen for seven consecutive months. We believe that North American REITs have already priced in the potential for recession, just as information technology and consumer discretionary stocks have. Historically REITs have outperformed during and after recessions and after rate hike cycles have finished. Given the strong fundamentals in several sectors, North American REITs are poised to deliver strong total returns going forward **(Exhibit 4)**.

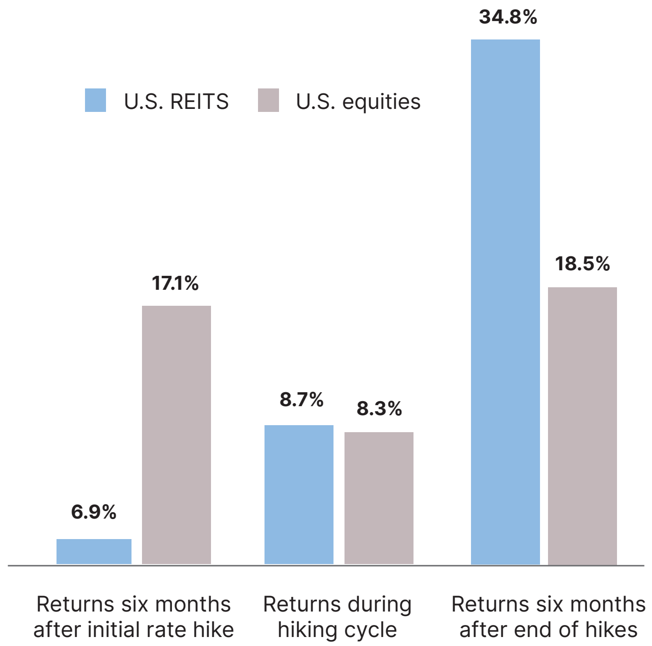
Exhibit 4 - US REITs have historically outperformed diversified equities following Fed rate hike cycles and recessions

Average annualized total returns before, during, & after U.S. recessions



Source: Nareit

Average annualized total return during and after rate hike cycles



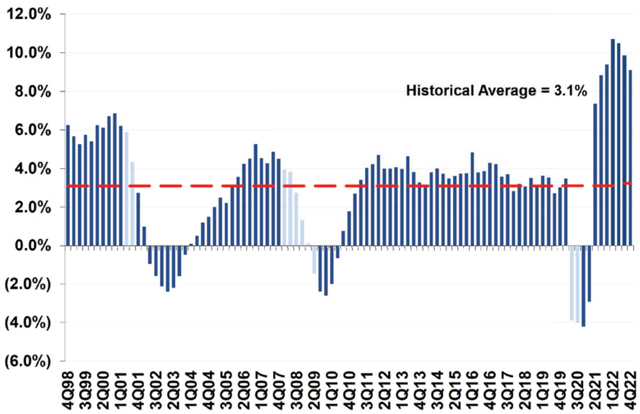
Source: Nareit

The real estate sector is making headlines for the struggles of the office sector. Prominent landlords such as Brookfield and Blackstone have defaulted on loans tied to office assets. We believe that many owners of office assets will initiate "strategic defaults" in order to commence negotiations with their lenders. The lenders face the choice of taking over ownership of the asset (in this case, office assets with declining occupancy) or negotiating more favourable renewal terms with the borrower. Large, sophisticated investors such as Blackstone and Brookfield have the financial and human resources to engage in these tactics.

Most North American REITs have an investment grade credit rating which they use to issue unsecured debentures as opposed to mortgages secured to specific assets. This provides them with greater financial flexibility and a lower cost of debt on what is generally a top quartile portfolio of real estate assets. During the global financial crisis ("GFC") only one REIT (mall owner General Growth Properties Inc.) experienced financial difficulties tied to refinancing debt. During the COVID-19 pandemic only two REITs (mall owner CBL & Associates Properties Inc. and shopping centre owner Washington Prime Group) experienced financial difficulties tied to refinancing debt. The overwhelming majority of publicly-traded REITs simply refinanced their debt (short term mortgages, paydown of principal) in a tactical manner to reduce debt service costs and sailed through the GFC and the COVID-19 pandemic.

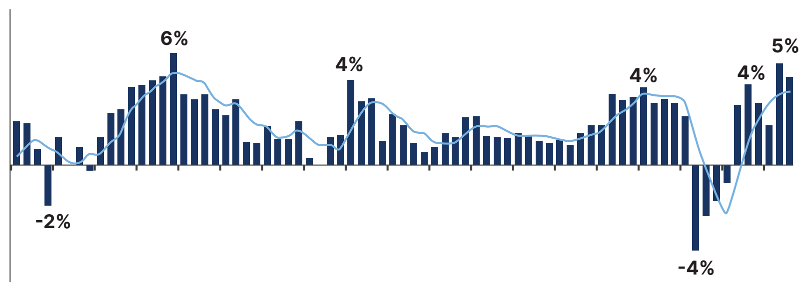
Residential, industrial, tower and data centre REITs enjoy long-term structural growth drivers and the resultant net operating income ("NOI") growth will offset much of the expansion in cap rates from rising interest rates. North American REITs are generating historically strong NOI growth despite the pandemic, rate hikes and slowing economic activity **(Exhibit 5 and 6)**. For each of these sectors, demand remains high and supply remains muted (in some cases a spike in 2023 followed by immediate mean reversion), leading to high occupancies, high rent growth funding cash flow and distribution growth.

Exhibit 5 - REIT same-store NOI growth only has turned negative in recessions



Source: Citi

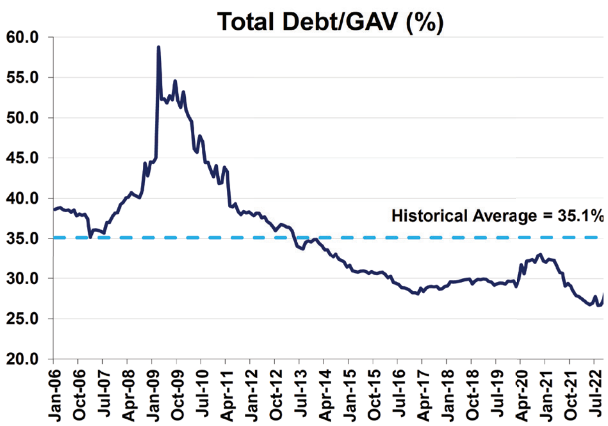
Exhibit 6 - Same-property NOI growth (2004 to Q3/22)



Source: RBC

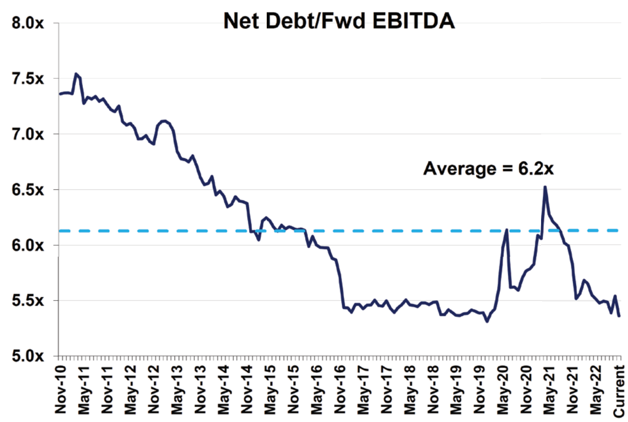
During the GFC US real estate suffered far worse than Canadian real estate. US REITs carried aggressive levels of leverage and elevated payout ratios inspired by what they saw as peak occupancy. Today US REITs are in far better shape with approximately 30% Total Debt/Gross Asset Value **(Exhibit 7)**, 5.4x Net Debt/Forward EBITDA **(Exhibit 8)**, and over 7 years average term to maturity on their debt **(Exhibit 9)**. All of these variables are significantly better than their long-term averages and demonstrate the financial health of the US REIT sector.

Exhibit 7 - Historical debt to gross asset value



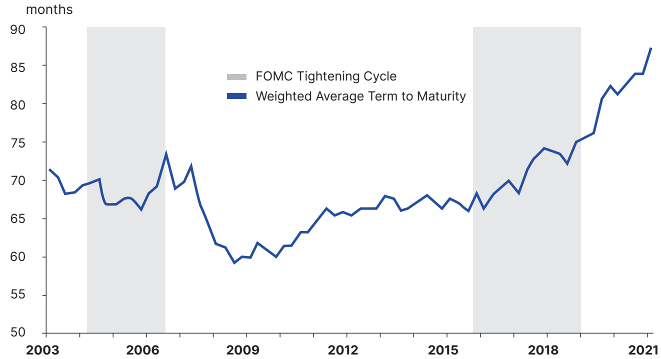
Source: Citi

Exhibit 8 - Historical net debt to NTM EBITDA



Source: Citi

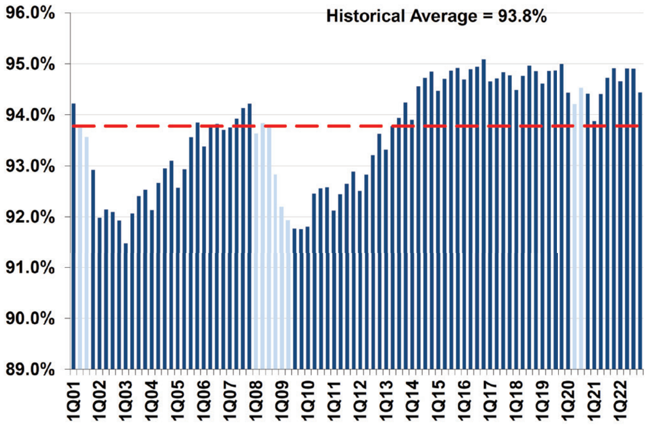
Exhibit 9 - Weighted average term to maturity over 7 years for REITS



Source: Nareit

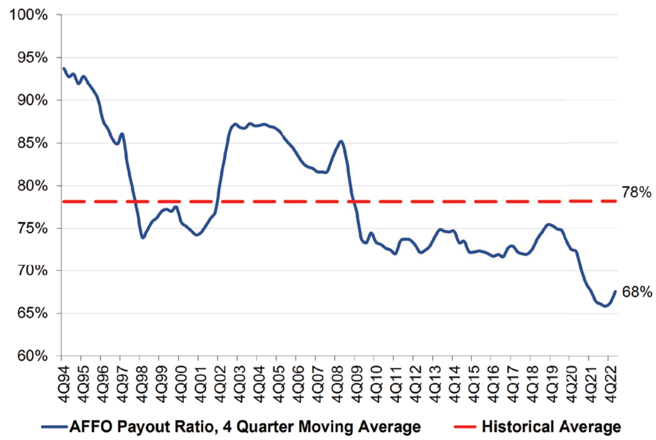
Supported by high occupancies and low new supply, US REITs have generated strong rent and cash flow growth. This has allowed them to increase dividends consistently even as payout ratios have fallen **(Exhibit 10, 11 and 12)**. The yield advantage that US REITs enjoy over diversified equities makes them an attractive income option even with guaranteed investment certificates offering four percent yields.

Exhibit 10 - REIT occupancy is near peak levels



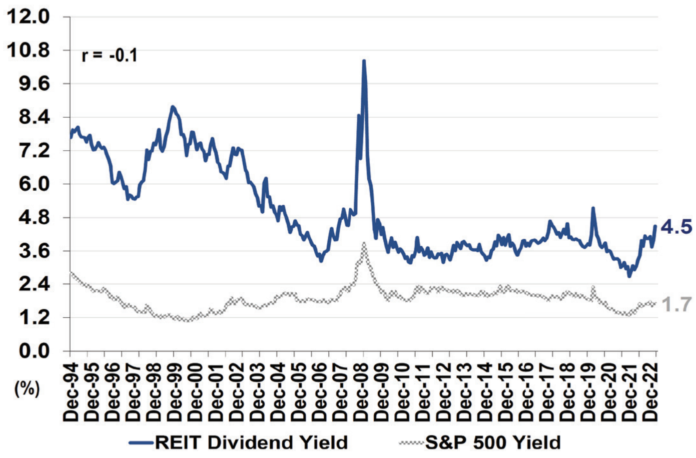
Source: Citi

Exhibit 11 - Historical dividend payout ratios



Source: Citi

Exhibit 12 - REIT dividend yield vs. S&P 500 yield

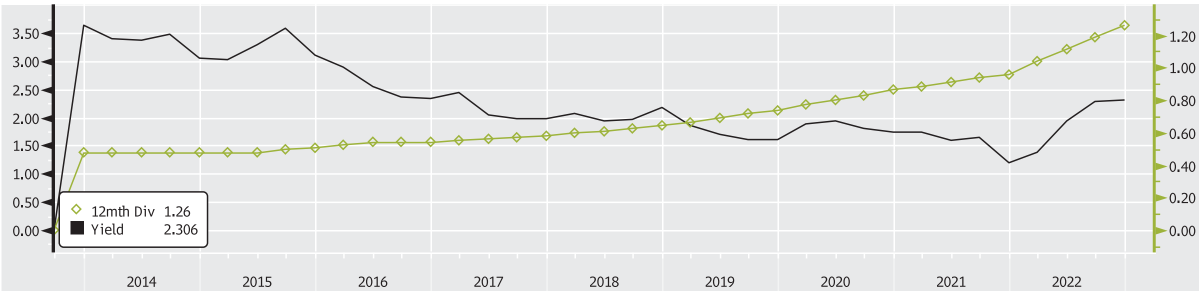


Source: Nareit

The Starlight Global Real Estate Fund is a concentrated portfolio of global real estate securities with strong cash flow generation and consistent dividend and distribution growth. In 2022, the portfolio experienced 31 dividend and distribution increases with an average increase of +12.7%. This trend continues in 2023 with 11 dividend and distribution increases with an average increase of +16.2%. The portfolio is focused on sectors (residential, industrial, cell tower, data center) with high occupancy and demand, low supply and strong rent growth. While investors may be tempted to simply allocate capital to large cap REITs, we have found opportunities in small and mid-cap North American REITs in each sector that offer greater distribution growth potential. Examples include the eight North American REITs listed below.

Industrial REITs

Rexford Industrial Realty Inc.

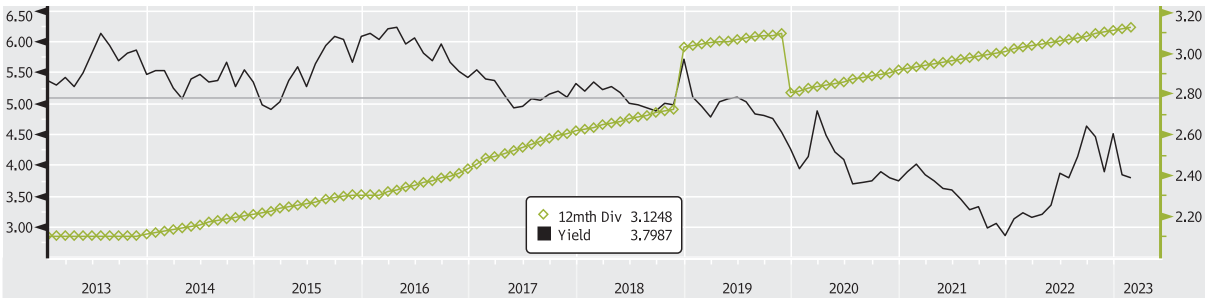


Current Yield:
2.6%

Dividend CAGRs:
1 Year 31.3%
3 Year 19.4%
5 Year 16.8%

Source: Bloomberg

Granite REIT



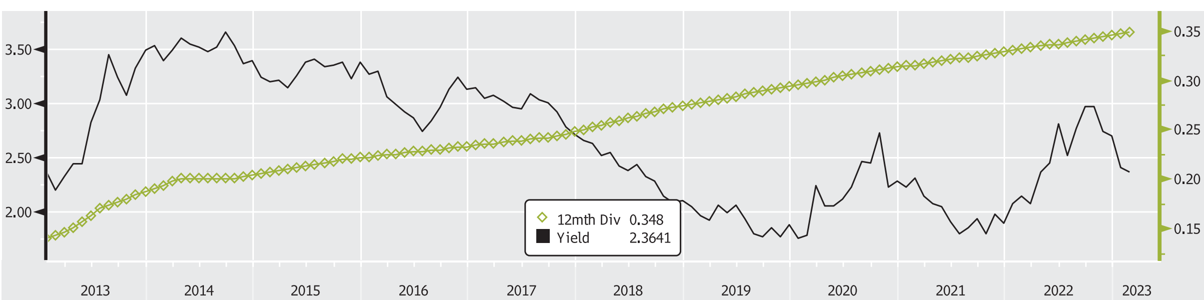
Current Yield:
3.9%

Dividend CAGRs:
1 Year 3.3%
3 Year 3.4%
5 Year 3.5%

Source: Bloomberg

Residential REITs

InterRent REIT

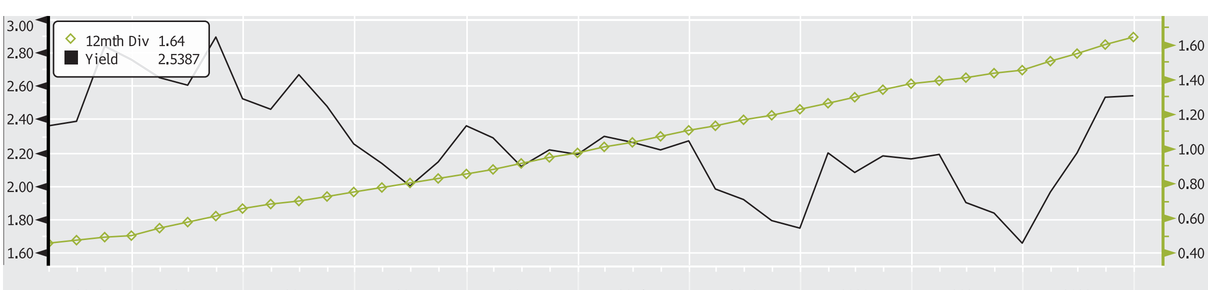


Current Yield:
2.8%

Dividend CAGRs:
1 Year 5.1%
3 Year 5.5%
5 Year 6.7%

Source: Bloomberg

Equity Lifestyle Properties inc.



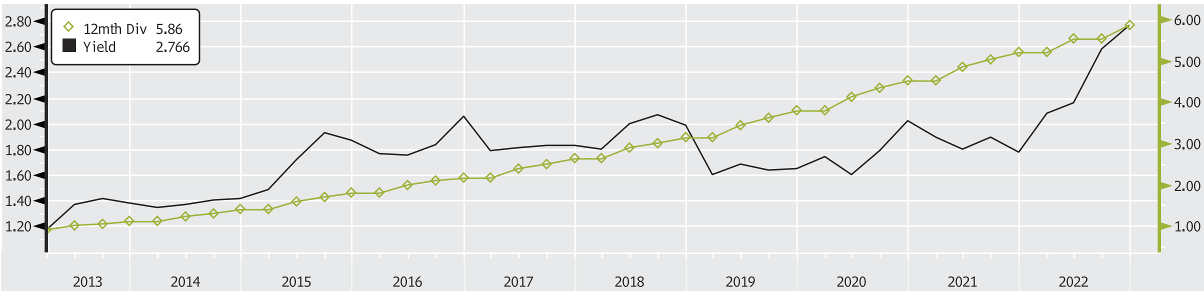
Current Yield:
2.7%

Dividend CAGRs:
1 Year 13.1%
3 Year 10.2%
5 Year 11.0%

Source: Bloomberg

InfraTech

American Tower Corp.

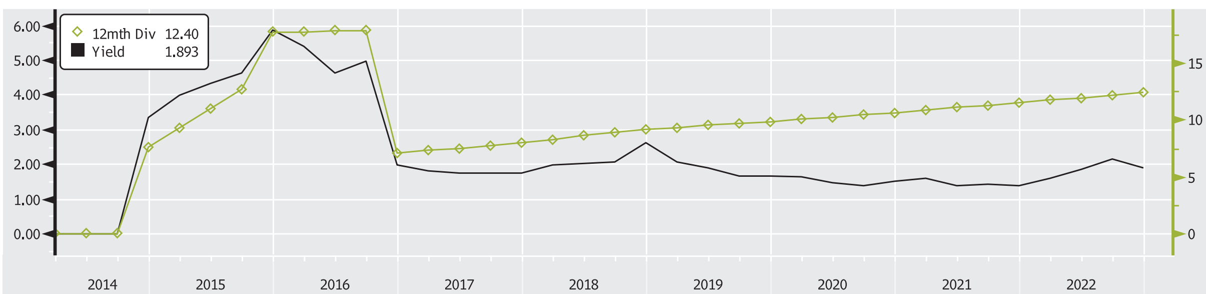


Current Yield:
3.1%

Dividend CAGRs:
1 Year 12.5%
3 Year 15.7%
5 Year 17.5%

Source: Bloomberg

Equinix Inc.



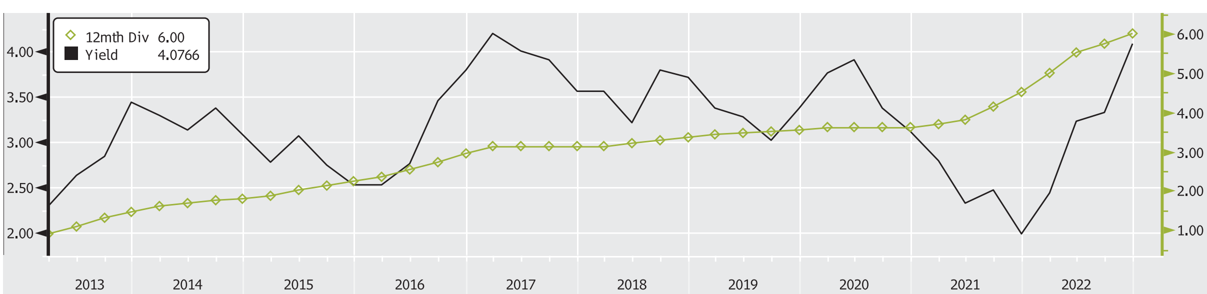
Current Yield:
1.9%

Dividend CAGRs:
1 Year 8.5%
3 Year 8.2%
5 Year 9.0%

Source: Bloomberg

Storage

Extra Space Storage Inc.



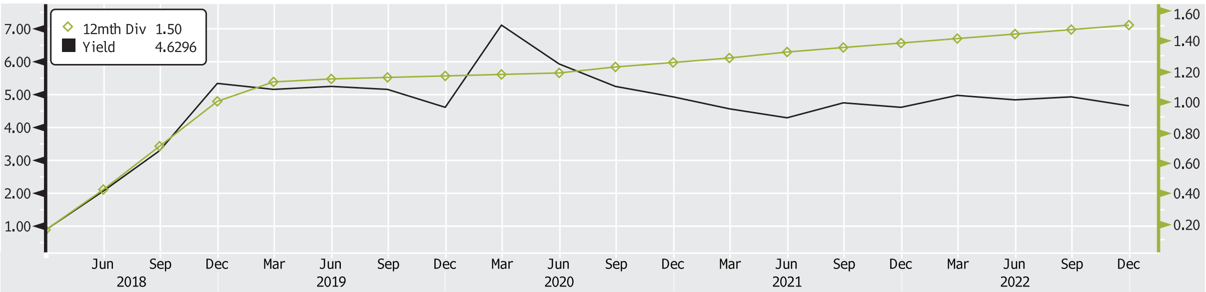
Current Yield:
4.0%

Dividend CAGRs:
1 Year 22.4%
3 Year 19.4%
5 Year 14.4%

Source: Bloomberg

Triple Net Lease

VICI Properties Inc.



Current Yield:
4.9%

Dividend CAGRs:
1 Year 8.5%
3 Year 9.4%
5 Year 57.1%

Source: Bloomberg

The current discounted valuation in the sector also allows investors to purchase the fund with a 6.7% tax-efficient yield (Series F, 65.6% return of capital and 29.3% capital gains in 2022) paid monthly, while allowing for strong capital appreciation as inflation falls and the global rate hike cycle ends. While market uncertainty and volatility are high, the total return opportunity in North American REITs is compelling.

We invite you to partner with us.

Investment Management Team

Dennis Mitchell, MBA, CFA, CBV
Chief Executive Officer and Chief Investment Officer

Portfolio management for the Partnerships are led by Dennis Mitchell, Chief Executive Officer and Chief Investment Officer.

Dennis has 20+ years of experience in the investment industry and has held executive positions with Sprott Asset Management, serving as Senior Vice-President and Senior Portfolio Manager, and Sentry Investments, serving as Executive Vice-President and Chief Investment Officer.

Dennis holds the Chartered Financial Analyst and Chartered Business Valuator designations and earned a Master of Business Administration from the Schulich School of Business at York University and an Honors Bachelor of Business Administration degree from Wilfrid Laurier University.

About Starlight Capital

Starlight Capital is an independent Canadian asset management firm with over $1 billion in assets under management. We manage Global and North American diversified private and public equity investments across traditional and alternative asset classes, including real estate, infrastructure and private equity. Our goal is to deliver superior risk-adjusted, total returns to investors through a disciplined investment approach: Focused Business Investing. Starlight Capital is a wholly-owned subsidiary of Starlight Investments. Starlight Investments is a leading global real estate investment and asset management firm with over 360 employees and $25B in AUM. A privately held owner, developer and asset manager of over 77,000 multi- residential suites and over 8 million square feet of commercial property space. Learn more at www.starlightcapital.com and connect with us on LinkedIn at www.linkedin.com/company/starlightcapital/

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For more information on our investment solutions, learn more at **starlightcapital.com** or speak to our Sales Team.

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