PALOS

Weekly Commentary

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By Charles Marleau, CIM

Why Boardwalk Real Estate?

The COVID-19 pandemic has inspired sector wide panic selling in multi-residential real estate investment trusts (REITs). Companies such as Boardwalk (TSX: BEI-U), Minto (TSX:MI-U), InterRent (TSX:IIP-U), Canadian Apartment Rentals (TSX:CAR-U), Mainstreet Equity Corp.(TSX:MEQ) and Killam Apartment REIT (TSX:KMP-U) have seen their stock prices severely impacted. The selloff has been exacerbated by investor fear that tenants, as a result of a job loss, will not have the capacity to pay their rents.

I've been pouring over multiple reports from analysts and my takeaway is as follows. Given the extreme level of uncertainty regarding the timeline of the COVID-19 crisis, it is very difficult to assign with any degree of certainty when the crisis will end (although it eventually will). Net Operating Income (NOI) estimates range from -15% to -25%. The result is the nonsensical panic selling we've seen in the multi-residential REIT's.

Toronto, Vancouver, Ottawa and Montreal have all experienced significant increases in NOI over the last five years. Rents have been increasing and this trend has sustained. As rents increase, this obviously leads to increasing NOI, and ultimately to a rise in Net Asset Value (NAV). This is all great for REIT investors; until the music stops. Prior to the onset of the pandemic, home affordability was a big problem for tenants in Canada's major cities so we can only imagine the increased difficulty we'll now see. To makes matter worse, these cities have significant workforce exposure to retail, tourism, hospitality, education, restaurants, and services.

Taking a similar look at our western cities (Calgary, Edmonton, Winnipeg and Regina), we are seeing the effects of a 'double-whammy'. While the COVID-19 impact has not been as severe, to date, there has been a significant economic impact on energy (oil & gas) and agriculture (which is essential). Oil & Gas is being further challenged as it's now caught between the OPEC/Russia pricing war and demand destruction from a slowing global economy. Cyclical impact in our Canadian oil & gas industry in nothing new as we've been challenged by low prices for Canadian crude over the past five years. As a silver lining of sorts, Canadian energy companies were already lean coming into this crisis having focused on generating free cash flow and paying down debt. Thus, much stronger balance sheets and lower debt than U.S. peers. It's hard to believe that these companies could cut more without cutting into the bone. Most of the layoffs have already been done.
For Western Canadian based REITS like BEI-U and MEQ, this is not their first slowdown. There have been three significant slowdowns in the last fifteen years and the fact is, the management teams of BEI-U and MEQ

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are experienced in dealing with such economic challenges as they've been through this before. On another note, residential/housing is an essential service and there is strong speculation that Canadian finance minister Bill Morneau will be implementing loan programs for oil & gas companies in the coming days. Further relief could come from President Trump pressing Russia and Saudi Arabia to agree on a coordinated ten million to fifteen million barrel per day supply cut.

All of this leads to us to ask one obvious question; who's going to pay the rent? While it's difficult to argue with the rationale behind the multi-residential selloff, its equally difficult to ignore the fact that some of the names have sold off so significantly that I now see a deep value opportunity. The recent volatility has created a disconnect where some REITs have been severely punished while others remain expensive on a relative basis. The market doesn't seem to care. This makes me question why REITs like BEI-U and MEQ are trading at 60% and 50% discounts to NAV respectively, while CAR-U, MI-U, and IIP-U are only trading at 28%, 17%, and 15% discounts? This huge discrepancy in valuation leads me to deduce that this is unwarranted. NOI in Toronto, Montreal, and Vancouver will be under pressure until we reach a rental affordability balance. Don't forget, rents were skyrocketing over the last few years. Alberta and Saskatchewan did not experience the equivalent magnitude of rent increases. Calgary, Edmonton, and Regina remain much more affordable. There will be some NOI pressure in these markets but not to the same degree as in Toronto, Montreal and Vancouver. In my opinion, there is tremendous value in in BEI-U and MEQ.

Related links:

Canadian Labour force characteristics by industry:
https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1410002301

Canadian restaurant sector laid off 800,000 in March, with wave of permanent closures expected this month.
https://business.financialpost.com/news/retail-marketing/canadian-restaurant-sector-laid-off-800000-in-march-with-wave-of-permanent-closures-expected-this-month

Disclaimer: Palos Funds are shareholders of BEI-U.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$5.63	-31.54%
Palos Equity Income Fund - RRSP	PAL101	$4.09	-26.79%
Palos Merchant Fund L.P. (Dec 31, 2019) [2]	PAL500	$1.71	20.15%
Palos WP Growth Fund - RRSP	PAL210	$4.82	-37.11%
Palos-Mitchell Alpha Fund (Fund Initiated on Jan 29, 2019) [3]	PAL300	$6.44	-37.88%
S&P TSX Composite (Total Return with dividends reinvested)			-23.50%
S&P 500 (Total Return with dividends reinvested)			-22.56%
S&P TSX Venture (Total Return with dividends reinvested)			-33.45%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			0.59%
Canadian Government 10-Year			0.71%
Crude Oil Spot			US $28.34
Gold Spot			US $1,633.70
US Gov't10-Year/Moody BAA Corp. Spread			395 bps
USD/CAD Exchange Rate Spot			US $0.7039

[1] *Period ending April 3, 2020. Data extracted from Bloomberg*

[2] *Fund is priced annually*

[3] *Fund is priced weekly on Tuesdays*

Disclaimer:

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