SEPTEMBER 2022

QUARTERLY UPDATE

Evolve Slate Global Real Estate Enhanced Yield Fund

BILT is an actively managed fund that aims to provide a recurring income from the underlying rental income derived from publicly listed real estate issuers. Through BILT, investors may benefit from the real estate investing experience of Slate Securities L.P., with the added value of an active covered call strategy applied on up to 33% of the portfolio.

TSX **BILT**

ETF TICKER: BILT (HEDGED)

SLATE

Slate Securities is an investment management platform specializing in real estate investing, across the public and private real estate markets. As a wholly owned subsidiary of Slate Asset Management, a global investment and asset management platform focused on real assets, Slate Securities benefits from deep expertise, insights and Slate investment opportunities. Slate Securities was founded with the objective of being the real estate solution for allocators.

REITS GLOBAL OVERVIEW

After a slightly negative Q1 due to geopolitical uncertainty, GREITs had a marked negative performance in Q2. Attention pivoted to inflation, as the transitory nature of higher data could no longer be supported. Supply chain disruptions, spiking commodity prices and general lack of labor all led to jumps in published data that have forced central banks to react, starting an interest rate increase cycle. For real estate, increasing cost of capital, with funding costs up and share prices down, will likely lead to pressure on asset values in most sectors. While we see some pricing readjustments as unavoidable, we see many opportunities where share prices have overreacted and now present discounts to where we believe assets will eventually stabilize. The silver lining for real estate is that the current cycle was characterized by high development costs, leading to low risk of excess supply in most sectors.

We noted in Q2 that REIT sectors which outperformed in 2021 have been some of the worst performing year to date. The industrial, residential, and self storage sectors performed poorly. Given the strong underlying fundamentals, however, the magnitude of the negative performance is a bit of head scratcher. Some of the underperformance may be related to the fact that these sectors started the year with lower yields and as such potentially more at risk from rapidly rising interest rates and increasing cap rates. By the end of the quarter, however, implied cap rates for these sectors stood well above cap rates we observe in the private market re-enforcing our view of the value currently being offered by REITs.

We saw an outperformance of the Asian region which remains less impacted from the current inflationary factors affecting North America and Europe. After years of near zero inflation, Japan saw a marginal pick up towards 2.5% which is a net positive for real estate (i.e. moderate inflation with continued low rates). The current environment should allow for gradual increases in rental income while financing costs are expected to remain low.

Given the sell-off in REIT pricing during the quarter the office, industrial and residential sectors are currently trading at levels below those reached at the onset of the pandemic and in many cases well below fair value. The healthcare and self-storage sectors are trading closer to their underlying property values but remain attractively valued versus history. The direct or private real estate market, on the other hand, has not seen the same degree of value correction as the listed market. The true level of values is often somewhere in between what the public market implies and where the slower to adjust direct market trades. With financing costs now creeping above private market cap rates there is a risk that private market values correct in the medium term. In many cases, however, this is already more than reflected in public market implied cap rates.

REAL ESTATE THEMES MOVING THE MARKET

One of the most dramatic movements during the quarter was the movement in industrial REIT pricing. Following new highs which were reached during the pandemic as e-commerce and reshoring demand drove demand and pricing for industrial REITs, the sector performed less well in 2022 following an announcement by Amazon which signalled they would reduce expansion and spending plans for warehouse space. The announcement negatively affected industrial REITs compared to the global index. That said, one can question the real impact of the news concerning the fundamentals of the sector. First, Amazon's shares of US rental volume have already been declining for 2 years. And second, the share of e-commerce represents less than a tenth of the total demand for industrial REITs. Thus, the markets' concern about the negative headline could prove to be exaggerated.

Labor market concerns have been another key theme in 2022 as shortages have impacted those with heavy operational platforms such as healthcare and cold storage REITs. During the quarter the labor market regained its bearings with a gradual return of the workforce. Over the last two years, operationally intensive REITs, such has healthcare and cold storage industrial, had to pay more to recruit a scarce workforce. This trend reversal could thus provide a relief for the REITs by offering them better control of expenses and improved operating margins. The outperformance of operationally intensive stocks during the quarter compared to the global index shows this thematic started to play out.

Retail REITs were resilient in the first quarter as leasing fundamentals remained robust. That changed in the second quarter as sentiment towards retail REITs veered negative for two reasons. The first occurred when large retailers, such as Target, announced warnings that profits would fall as retailers were stuck with too much inventory and would have to discount products. The second pertains to the consumer itself. Consumer sentiment has weakened throughout the year, recently reaching decade lows leading to fears of a decrease in demand from consumers. The combination led to retail REITs falling as much as 27% during the quarter. The drop, however, has created a significant divergence between Malls and Strip Center retail, leading to attractive valuations in malls relative to their strip center peers.

Japanese developers have stood out this year, handily outperforming J-REIT peers as well as global REITs. We believe a portion of this outperformance is attributed to the current inflation environment in Japan. Inflation has picked up rapidly this year in Japan relative to its history but remains low in absolute terms at only 2.5%. The lower inflation helps both Japanese developers and J-REITs. Within the country, however, the advantage goes to Japanese developers. With stronger pricing power, they can adapt faster than JREIT to any changes in prices.

In Europe, the region’s poor returns have been largely driven by a rising interest rate environment and the ongoing conflict in Ukraine. As a point of reference, 10- German bond yields rose to 1.4% by the end of Q2 compared to negative rates a year ago, while Swedish 10-year bonds increased to 1.69% over the same period. Given the rapid increase in yields, sectors with the high leverage and short-term maturities delivered the largest relative underperformance. As such, the Nordics, with an average loan to value ratio above 50% and roughly 44% of its bonds maturing before 2024, including over 20% in 2022, was the worst performing sector, returning -42% year to date. Sectors that also underperformed given their elevated leverage ratios included Germain Residential and European Office.

IN SUMMARY

Inflation moved higher during the quarter forcing the hand of central banks to raise rates and reduce stimulus which the market fears might result in a recession. The result was a dramatic fall in the share price of REITs with low yielding asset classes suffering the most. REIT valuations have now diverged sharply from private market values and compared to history present and attractive entry point for the asset class. Balancing fundamentals and valuation, we are most positive on global industrial, cell towers and North American residential. We are most cautious on U.S. Data Centers and lodging as well as Swedish companies.

Evolve ETFs
Scotia Plaza, 40 King Street West, Suite 3404, Toronto ON M5H3Y2
416.214.4884 | 1.844.370.4884 | www.evolveetfs.com