Financial Post – August 15, 2024

Real estate investing has taken a hit, but not all markets are the same

Assets can go through cycles, sometimes for years, where both significant underperformance and outperformance are observed

David Kaufman || August 15, 2024

Buildings under construction are pictured in Surrey, B.C. on June 26, 2024. PHOTO BY THE CANADIAN PRESS/ETHAN CAIRNS

The sometimes striking oversimplification of investing themes and sectors is nowhere more prevalent than in the column inches and bandwidth devoted to real estate, which is often depicted as some kind of monolithic investment that is uniform across all geographies, sectors and investors.

But peel the onion's layers back and you'll see that real estate investing is multifaceted, diverse and begging for specific and detailed analysis. Investors willing to apply thoughtful work across the real estate spectrum will discover that it is not only possible that various types of real estate across multiple jurisdictions can perform very differently amid varying market conditions, but likely.

One of the oldest adages in real estate investing is that "real estate is local." This saying emphasizes that markets significantly vary across different geographies and jurisdictions. These variations apply not only to populations, culture and trends, but also to politics at national, regional and municipal levels.

A stick-built, multifamily rental project might be just what's needed at a point in time in Lethbridge, Alta., or Gananoque, Ont., but a 50-storey condo project might be more appropriate in Vancouver or Montreal. A data centre project or Amazon.com Inc. depot might work in Toronto or Halifax, but a standalone grocery-anchored plaza could be what is called for in Uxbridge, Ont., or Sydney, N.S.

Real estate varies by geography and jurisdiction, as well as by type. The four main categories of real estate are residential, commercial, industrial and office. With the exception of residential — which, while not always universally "hot," will never be too cool for too long — real estate assets can go through cycles, sometimes for years, where both significant underperformance and outperformance are observed.

All real estate investing — irrespective of type — can be distilled into two sides of the same coin: real estate development and construction and income-producing real estate.

For example, a development project to build an office tower in downtown Calgary could result in a developer doubling or even tripling its equity over a three-to-five-year period, while the buyer of the project, once fully stabilized, would be looking for long-term, tax-efficient income and moderate inflation-fuelled growth rather than multiplying the value of the equity they invest.

In recent years, as interest rates have steadily risen, analysts have justifiably focused on how they affect real estate investing, which has been quite dramatic in some cases. Coupled with inflation, market disruptions and the general hangover of COVID-19 (all of which are both the cause and the effect of the increase in rates), and various real estate sectors have really suffered.

Nowhere is this more prevalent than in the office sector, where businesses have shifted work policies in a post-pandemic world to the point where many require much less space, if any, to operate. This has led to historic downsizing, lower rents, higher vacancies and a downward secular trend that may take years to reverse, if ever.

Commercial real estate has also taken a virtually universal hit because consumer behaviour has shifted, perhaps permanently, towards a model for goods that can be delivered to your door and services that can be delivered over the web.

Real estate development has taken a big hit because much higher input costs (including the high cost of construction financing) have collided with higher inventories in the resale market, making it difficult for developers to rely on pro forma projections showing adequate profits for the risks involved.

Multifamily rental real estate, on the other hand, while certainly not immune from the pressures of higher costs, has experienced a halcyon moment, at least in Canada, where rents and profits have steadily increased in one of the most lopsided supply-and-demand environments ever to be observed in this country.

With little prospect of feckless government intervention closing the gap between the demand for rental housing and its very limited supply, this condition is expected to remain in force for years to come.

One need look no further than urban centres in the United States to observe quite the opposite dynamic unfolding in the multifamily rental sector. The combination of construction-friendly municipal regulatory environments and far lower immigration effects down south has conspired to result in lower rents and profits during the same period.

It is always true that high-quality investing in any asset class or sector requires significant time, effort and analysis. Professional investors know this and devote little weight to media coverage that paints a whole sector with a single brush and leaves the impression that entire markets move up or down in concert.

You should certainly consume as much legitimate media coverage as possible when doing your own investing analysis, but do so with a discerning eye to separate the specific areas of the market that might be struggling from those that are excelling. It is possible to achieve attractive risk-adjusted returns, especially in real estate investments, when you forego the general in favour of the specific.