Trez Capital | Market Updates & Insights
A Letter from Trez Capital's President & COO

Over the past 12-18 months several key factors have led to inflation levels not seen in decades[1] – from governments responding to the COVID-19 pandemic by opening the money supply 'flood gates', to the havoc the pandemic has played on supply chains, and more recently, the war in Ukraine.

To fight inflation, both the U.S. Federal Reserve Board and the Bank of Canada have already started their overnight rate hikes. This monetary tightening, together with geopolitical tensions that emerged earlier this year, is resulting in new stock market volatility both in Canada and the United States. While rates on the long dated 10-year U.S. Treasury Bills have very recently backed off to sub 3.0%, the consensus is that short-term rates will continue to rise over the course of this year and next[2], although, the full extent of increases remains uncertain.

Broadly speaking, the increase in rates will influence the real estate development market. Although, at this time, we have not seen any deterioration in values yet, we have observed a modest slowdown in development activity as developers attempt to reconcile uncertainty in costs and interest rates with uncertainty in value. In both Canada and the U.S., inflation and increasing rates will sideline marginal projects and start to soften supply in the short-term.

Despite new risks, we continue to see strong opportunities in our focus markets. Several factors continue to support our investment philosophy. In a slower growth scenario (or even a recession), we expect the markets in which we operate to outperform.

Continued housing demand

A chronic undersupply of homes remains in both Canada[3] and the U.S.[4] For the U.S., according to recent research by Rosen Consulting Group "…in order to fill an underbuilding gap of at least 5.5 million housing units during the next 10 years … building would need to accelerate to a pace that is well above the current trend, to more than 2 million housing units per year. This would represent an increase of more than … 60%, relative to the pace of housing production in 2020 of less than 1.3 million units".[5]

Demand is still rising for both for-sale homes and rental apartments. In Canada, immigration will continue to fuel demand in the major urban centers where we operate. Meanwhile, new development approval processes within local municipalities remain cumbersome.[6] The lack of ability to keep up with demand will likely continue to support values in the for-sale home market and thus continue to plague affordability. Favorable pro-growth business environments will continue to drive net migration[7] and job growth[8] into the Sunbelt states in the U.S., underpinning continued strong demand for homes and allowing those markets to outperform.

In the U.S., most of Trez Capital's loans are to single-family lot developers and rental apartments. Most lots are pre-sold to either national or large regional homebuilders[9] and housebuilders are well capitalized and have lots of cash on hand.[10] According to John Burns Real Estate Consulting, lot shortage is the number-one threat to fulfilling sales commitments and growth objectives among the builders.[11] Homebuilders are still operating at record margins and thus have some margin to give, therefore mitigating some of the downward pressure that increasing rates would have on prospective homebuyers. Further, if for-sale housing demand should tail off, this would create greater demand for rental apartments and rental homes.

Trends, challenges and opportunities

As a result of the global supply chain challenges that the pandemic exposed, western countries (especially the U.S.) have reversed course on the longstanding offshoring trend by pursuing onshoring of certain critical and strategically important manufacturing capabilities. The U.S., for example, has provided incentives that will drive a dramatic lift in chip manufacturing. In the past six months, three new multi-billion-dollar plants have been announced in Phoenix, Austin, and Dallas – all markets that we serve. While the trend has long-term inflationary impacts, it will drive critical job growth and real estate demand in the near term.

Real estate ownership has always been an excellent hedge against inflation. In 2021, the NCREIF ODCE index (an index of the largest private real estate funds) recorded a return of 22.2%, whilst inflation in the U.S. surged to 7.1%.[12] Through Trez Capital Private Real Estate Fund Trust (TPREF), Trez Capital has been actively constructing a portfolio concentrated around the residential sector, particularly rental housing, as well as lot development and self-storage. These sectors have favorable characteristics for inflation-beating returns, as the U.S. housing market remains hugely undersupplied. Rental housing landlords also have the ability to regularly adjust rents and, in turn, income, which acts as an effective hedge against inflation. This increased income also positively impacts capital value.

For Trez Capital Opportunity Funds (TOFs), the portfolio continues to perform well. The more advanced development projects are showing strong signs of leasing activity as demand remains high, particularly across the Sunbelt states where the portfolio is concentrated. Trez Capital has built up an exclusive pipeline of new projects, which will continue to capitalize on the current market trends, with an investment focus on rental housing, lot development and self-storage.

What does all this mean for our debt fund yields?

Most of our loans are prime based, so as prime goes up, so does our interest. There is still substantial liquidity in the marketplace, which will continue to pressure credit spreads. As a result, our yields may not go up in lockstep with the overnight rate hikes.

Trez Capital's approach to risk management

Whether concerns focus on inflation, rising interest rates, or new geopolitical risks, there is no doubt that the present environment merits an extra degree of caution. Here at Trez Capital, we continue to maintain a focus on only the best sponsors that have strong balance sheets to weather the storm, and the capabilities to perform. Meanwhile, we will continue to focus on major markets in Canada and the U.S. Sunbelt states – markets that we believe will fare the best in a potential world of slower growth.

We have confidence that Trez Capital and its investors are well positioned to ride out these challenging times.

Dean Kirkham
President & Chief Operating Officer

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[1] In the U.S., the April 2022 CPI has increased by 8.3% vs previous year, which together with 8.5% increase reported in March 2022, constitutes the highest level since 1979-1981 double digit levels. Sources: U.S. Bureau of Labor Statistics, Minneapolis FED
In Canada, the April 2022 CPI recorded 6.8% vs previous year - highest on annual basis since 1982. Source: Statistics Canada, World Bank
[2] The survey of 48 economists conducted by Bloomberg from April 22 to 27 forecast the Fed will lift rates to a target range of 2.25% to 2.5% by December, while markets are pricing in around 2.75% at year's end. The last published forecasts by the Fed in March showed rates rising to 1.9% this year and 2.8% in 2023. Source: Bloomberg
[3] At 424 housing units per 1,000 residents, Canada has the lowest number of any G7 country. An extra 100,000 dwellings would have been required to keep the ratio of housing units to population stable since 2016. An additional 1.8 million homes are required to achieve the G7 average level of supply of housing relative to population (471). Source: Scotiabank
[4] 12.3 million American households were formed from January 2012 to June 2021, with 7 million new single-family homes built during that time, leading to an accumulated shortage of about 5.5 million homes as of beginning 2022. Sources: CNBC, Forbes, Wall Street Journal
[5] Housing is Critical Infrastructure: Social and Economic Benefits of Building More Housing (Rosen Consulting Group for the National Association of Realtors). June 16, 2021
[6] Development approvals are on average of 1.5 to 2-years, with applications requiring multiple application types being on average 20.3 months. In some cases, timelines exceed 30 months (OPA in Toronto). Source: Canadian Home Builders' Association
[7] Growth in population aged 15 and over is projected to average 1.1% annually during 2019-2028 period. The average immigration rate has historically been around 7.8 per 1,000 people in Canada, with immigration contributing 73% to overall population growth. Sources: Government of Canada's Immigration Levels Plan for 2022-2024, Employment and Social Development Canada
[8] An annual average growth in employment between 2020 and 2028 is estimated at 0.8% with labor force participation expected to increase across all major groups (25-54, 55-64, and 65+). Sources: Macroeconomic Outlook (2019-2028), Canadian Occupational Projection System and Statistics Canada
[9] E.g., Tri Pointe Homes' Colorado division controls the lots it needs for 100% of its planned deliveries for the next two years, while D.R. Horton acquired more than 1,300 lots last year from Lackland, a land development company. Source: probuilder.com
[10] The average cash and equivalents as percentage of balance sheet for selected largest U.S. residential homebuilders (DR Horton, Lennar, PulteGroup, NVR, Toll Brothers) has increased from 13% in 2012-2019 to 20% in 2020-2021, while their average gross profit margin went up by 3 percentage points on average for the same period from 21% to 24%. Source: companies' financials, SeekingAlpha
[11] https://www.probuilder.com/2021-housing-giants-where-is-land-for-home-building
[12] U.S. Consumer Price Index, 2021