JUNE 2020

# Cardinal Update

## REITS Beyond the Headlines

**As investment managers, it is important to approach negative headlines with a healthy dose of respect, but to also not be afraid to look beyond the headlines.**

What do we mean by this? Well, it is a two-fold process both to assess the arguments made through the negative headlines to gauge the risk, and then to evaluate whether there is an appropriate level of risk-reward available in any individual company within the sector that warrants investment consideration. Specifically, negative headlines can cause broad-based, indiscriminate selling of sectors that can leave quality companies trading at discounted valuations. Just what a value manager looks for.

During the COVID-19 pandemic, much of the workforce adapted to working from home. Having been exposed to this reality for the past eight weeks, suggestions that this will become everyday way of life have intensified. Headlines from Shopify's CEO that "office centricity is over" and Barclay's CEO declaration that big city offices "may be a thing of the past" help feed into this narrative. Further headlines suggest that a glut of office space being developed in major cities such as Vancouver and Toronto at a time of economic weakness will plunge the office market into a downward spiral. Is this pandemic truly the death knell for the office market that no one saw coming or does this present an investment opportunity for best-in-class operators that may have sold off?

Looking first at the implications of "permanent remote working" arrangements, the actual meaning will more likely mean a hybrid model for the vast majority of companies. This may mean a more rotational in-office work schedule that would reduce the number of employees in the office at any given time, but there is an offset to this. Over the past several years, office space per worker has been shrinking with the rise of open-office concepts and hotdesking; this trend will reverse as offices re-open and spaces need to be reconfigured to accommodate more social distancing measures, which in turn, will mitigate some of the negative impact to physical office space demand.

Another key point to mention is the record low vacancy rates we had going into the pandemic. This combined with consolidating suburban office space to the downtown cores of major cities necessitated the development of new office supply. The main difference we see for this office development cycle from past crashes is that there have been no speculative urban office development projects greenlit, meaning each of the projects have a significant portion of the space pre-leased in advance of development.

Focusing on industry leading operators in the Canadian office REIT space, a name that we have historically liked, but had gotten too lofty in valuation is Allied Properties REIT. With some of the comfort gained from the macro elements discussed above, the fundamental aspects of Allied are attractive as well. They have: a best-in-class balance sheet amongst Canadian REIT peers; a buffer against softening market conditions given that rents across most of the portfolio were well below market rates coming into the pandemic; significant development expertise and a large pipeline of development land that is currently attributed little to no value in the unit price; and, counteracting concerns around physical office space requirements, they control urban data centre assets in Toronto that we believe are currently undervalued on both their balance sheet and unit price.

So in closing, while at times, a negative news headline is worth delving into and assessing from a risk perspective, we find that it is equally true that it can also provide investment opportunities into quality companies at a discounted price.

### COMPANY FOCUS – SAPUTO

Saputo (SAP) is a global leader in the dairy industry and has a very strong management team. SAP is an experienced consolidator with a long, successful acquisition track record and has been able to generate significant synergies by implementing best practices and increasing the efficiency of acquired assets. While COVID-19 has created near-term puts and takes across SAP's business, with strong growth in retail but challenges in foodservice, SAP should be able to come out on the other side of the pandemic in a stronger market position than they went in.

Although fluid milk has been in decline for some time, SAP does not have much exposure to it outside of Canada as the majority of sales are in cheese and other dairy products. Cheese consumption per capita has steadily grown over the long-run and SAP offers a wide variety of cheeses from commodity-type products in the foodservice channel to high-end, value-added retail products. The company also co-manufactures for plant-based beverage companies given a similar process, and they are the largest plant-based creamer manufacturer in the world.

SAP has raised its dividend for 19 consecutive years and we expect mid-single digit annual increases into the future.

### DIVIDEND INCREASES

| | |
|---|---|
| Medtronic PLC | 7.4% |

(During the period May 1 to May 31, 2020)



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