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KEYNOTE INTERVIEW

Secondary markets positioned for growth

Covid-19 has brought US multifamily opportunities in secondary markets to the forefront, says David Smith, chief operating officer of Avenue Living Asset Management and chief executive officer of Avenue Living's US real estate trust

At first glance, Canadian real estate investment manager and operator, Avenue Living, launched their US multifamily strategy during a challenging time. The company opened its US office in December 2019, just before international borders began to shut down due to the pandemic.

However, Avenue Living already had over C$2.3 billion in assets under management, a vertically integrated platform of shared services, a finely honed model for investing in and repositioning class B and C multifamily residential assets across western Canada, and boots on the ground in the US, with dedicated staff to deploy its strategy throughout 2020 – something not many international peers were able to do. As of April 2021, Avenue Living had accumulated $100 million of multifamily assets across three different cities throughout the US, after successfully closing on its first US investment in October 2020.

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Q What sparked the interest to enter the US market?

It wasn't one deal or one marquee opportunity that drew our team to the US market; rather, reflecting on how successful we've been in various markets in Canada, and after years of research to determine if we could find secondary growth markets south of the border, we became confident in our strategy.

We believe there are compelling investment opportunities available in secondary markets – even beyond North America – where we can scale our platform and avoid competition in primary markets. We also believe the growth opportunities in select US secondary markets will outpace primary markets in North America, thanks to trends that have been seemingly amplified by the pandemic environment. One such

> *"The growth opportunities in select US secondary markets will outpace primary markets in North America"*

trend is the "flight to affordability," where we are seeing lower density living coupled with a higher standard of living as people start to seek more affordable accommodation.

That said, we spent a lot of time researching the competitive landscape and refining our business model, as necessary. With a 15-year track record of managing our own properties in Canada, we believe that it is important to align our investment strategy with local partners in the US, and therefore engage third-party managers who have deep, local market knowledge to manage our US assets.

Q The US economy has been struggling due to the long-lasting pandemic. What opportunities do you see for Avenue Living right now?

Avenue Living's counter-cyclical investment strategy has been successful in mitigating the negative effects of the pandemic. For us, it comes down to the ability to see long-term value, while maintaining a real estate operations team that can continue its high-performance track record during challenging periods.

While the challenges of covid-19 persist, we see compelling investment opportunities in the class B and C multifamily space in select secondary markets throughout North America. Our research supports a large-scale "flight to affordability" over time. Additionally, in the multifamily market in which we operate, the combination of skilled labor and increasing incomes are all potential benefits to investing within this asset class.

The secondary markets we target are further supported by stability in government, education, healthcare, manufacturing, construction, and logistics/distribution sectors. Our solid strategy has proven successful in

Q How are you creating value in Kansas City?

Our original acquisition in Kansas City's Prairie Village node consisted of 342 units across four properties for $39.75 million ($116k/unit). When we first identified it, the portfolio showed signs of mismanagement, and we saw value-add potential in unit renovations and improvements to existing amenities. We plan to continue unit and common area renovations with premiums of $200-$250 per month. In total, we plan to invest approximately $3.5 million into the four assets.

Q And how about in Colorado Springs?

Our first foray into the US took place in Q4 2020 with our purchase of 129 units in Colorado Springs for $13.9 million ($108k/unit.) Colorado Springs was an ideal market for our first US purchase with the population expected to grow at twice the rate of the US average. Net migration accounted for nearly two-thirds of the metropolitan area's population growth over the past four years, all of which has translated into robust demand for apartments.

The portfolio consisted of six contiguous buildings which we have now combined into one institutional asset. The value-add approach consisted of extensive exterior and interior renovations and the addition of attractive resident amenities (totaling a $3 million investment).

Canada, and we are enthusiastic about our expansion into the much larger US market and the potential even beyond that.

Q Most investors would consider Class B and C assets to have heightened risk. How do you convince new investors to see their value?

There are a few things to keep in mind. Even with Class A and AA assets, there is still economic cycle risk.

In the class B and C space, we are still able to maintain strong in-place cashflow, coupled with the ability to renovate and reposition in-line with market demand. In Colorado Springs, for example, market rents are growing at five per cent annually. As people seek out upgraded amenities, we have the ability to deploy strategic capital to enhance rents at a much faster rate than a multi-year development approach.

We aim to purchase properties at a discount to replacement costs (40 to 50 percent, in some cases). The margin of safety helps cushion our upfront investment even if new supply comes to market. We position our rental rates at a discount to newly built assets, providing affordable living options for the middle market. That discount to replacement cost is especially beneficial in conjunction with the "flight to affordability" we've observed across the US – and we're seeing positive absorption trends in the class B and C assets.

Moreover, we analyze submarkets to identify promising factors in each market we enter. Often, there is limited vacant land and therefore higher barriers to entry for new development. This allows us to achieve rent premiums on our renovation spend, while being somewhat insulated from new supply.

Q How does your US fund structure vary from your Canadian one, particularly in the role that investors play?

We have institutional investors involved with all of our funds, utilizing a Canadian tax-beneficial structure. Currently, the majority of our investors are Canadian, and we have focused on targeting high-net-worth individuals and family offices.

When we raise capital, we are aligning our management team, shoulder-to-shoulder, with our investors. Our management team invests personally in each fund, which creates that alignment with external stakeholders.

We aim to draw Canadian investors into the US market, but are also looking for US investors to partner with us. We have multiple funds in Canada, allowing investors to potentially diversify their risk and expand their portfolio.

"The markets that we were attracted to pre-pandemic, we found to be even more attractive after watching their 2020 performance"

Q You're currently in three cities in the US: Madison, Colorado Springs, and Kansas City. Which other markets are attractive, and why?

We spent years refining our US entrance strategy. We have a dedicated investment team in Houston that has been working hard behind the scenes. In 2020 alone, we underwrote $2.3 billion and over 20,000 units in our target US markets.

We currently have a presence in Colorado Springs, Kansas City, and Madison, and anticipate closing more deals in these markets during Q2 2021. Beyond these three markets, we are exploring additional locations including (but not limited to) Chattanooga, Cincinnati, Columbus, Knoxville, Lexington, Winston-Salem, Raleigh, Atlanta, and Houston. These cities fit the market model we built for market selection during our research phase.

Our market model takes more than 10 different factors into account, including economic diversification, education, expected rent growth, expected population growth, expected employment growth, market size and real estate investment yield.

These particular cities have been growing quickly in these areas, and we've identified a sizable gap between anticipated demand and new construction. Country-wide, there is currently a $600 gap between the class B and C rates and the class A rental rates, and we see an even wider margin in these markets.

Q What has been the greatest challenge upon entering the US at this time?

The most significant challenge for us was navigating the political landscape and border closures during covid-19. Transaction activity had to be limited during 2020, with many ownership groups electing to pause the disposition process.

Finding the right deal in a slow market was another challenge. Ultimately, the markets that we were attracted to pre-pandemic, we found to be even more attractive after watching their 2020 performance.

None of our preferred markets performed poorly in the multifamily space. It gave our data and research team the ability to understand what government support measures meant for various real estate markets, and what the impact of job losses would be on real estate and other industries. ■

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