BROMPTON FUNDS

Brompton Insights

October 2020

Back to the Office? Everybody's Home!

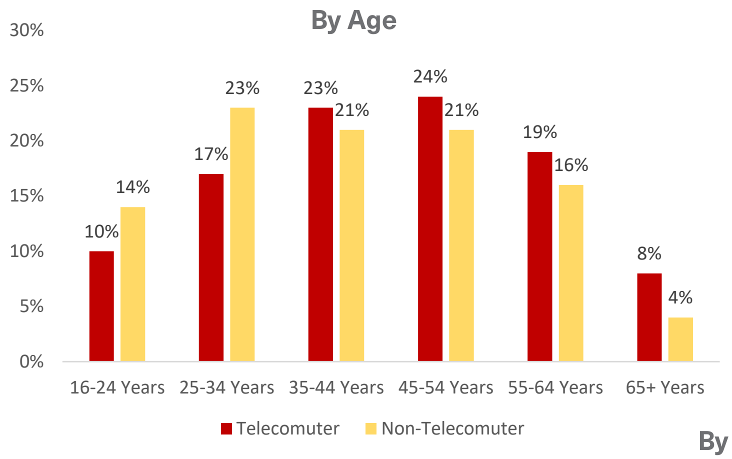
Fund in focus: Brompton Global Real Assets Dividend ETF ("BREA")

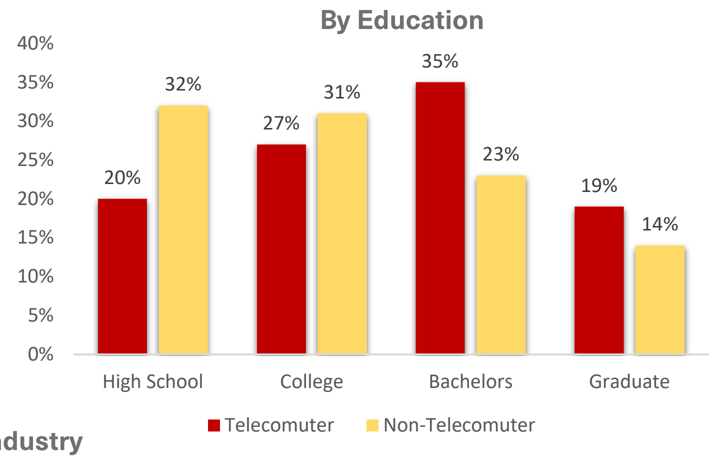
The COVID-19 pandemic has sent the majority of office workers home to work almost overnight. Many investors question whether work from home ("WFH") is here to stay, and more importantly, the broad implications of working from home on the office real estate sector amid COVID-19.

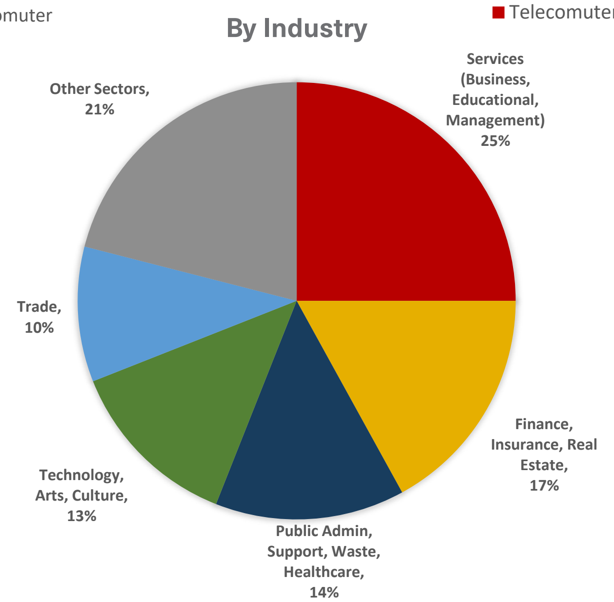
After the imposition of shelter-in-place orders, Statistics Canada estimated that an additional 4.7 million employees were working from home as of March 28, 2020, equivalent to about 39% of the workforce. In March Global Workplace Analytics estimated that 25%-30% of the U.S. workforce will be working from home multiple days per week by the end of 2021. Major high profile tech companies such as Shopify, Slack and Twitter have already announced that they will allow their employees to work from home indefinitely, while other tech and financial companies like Google and Scotiabank have agreed to let employees work from home until at least 2021.

Working from home has clear cost advantages for both employees and employers. A 2020 JLL survey found that employees are saving on approximately 22% of their typical spending by working from home, including expenses like transportation, work attire and meals. As for employers, Global Workplace Analytics estimated cost savings of US$5,100 per employee per year in areas such as real estate, utilities, attrition and travel costs. At the same time, 70% of employers believe employee performance and productivity from WFH are the same or better. On the other hand, human interaction and the desire to socialize with colleagues are often cited as the most missed element of the office. Working from an office can also encourage collaboration and team building, areas where technology fails to replicate.

WFH is not a one-size-fits all solution for all companies. Certain businesses can more readily adopt WFH than others and some have the option to permanently adopt WFH while other businesses cannot. As evident from the graphs below, the pre-pandemic telecommuting profile varies by age, education and industry. The 35-54 age group makes up about 47% of telecommuters, and employees with a Bachelor's degree account for 35% of all people telecommuting. Dissecting by industry, professionals working in the field of business, finance and administration are more likely to work from home than sectors such as manufacturing and customer service. The size of a business is also a factor to consider, as large businesses are more capable at offering telecommuting than small and medium-sized companies.





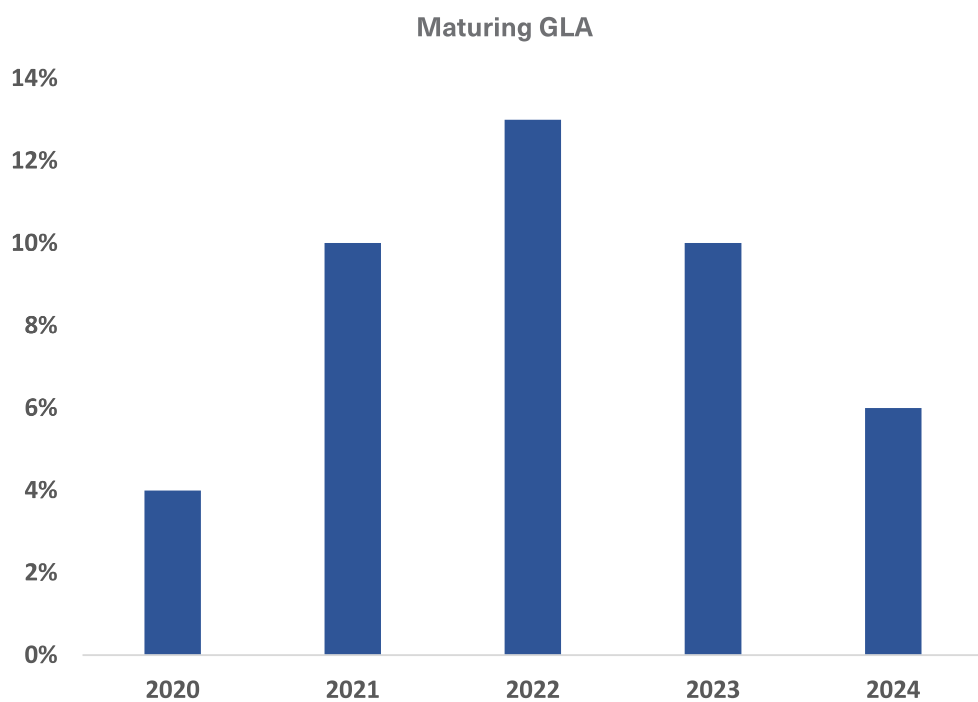


Source: 2016 American Community Survey, U.S. Census Bureau, Global Workplace Analytics, CIBC

As employers reconsider the role of office space in light of the pandemic, investors should consider several factors when assessing companies' ability to withstand WFH adoption.

1. **Geographic footprint and tenant exposure:** Downtown office properties in major city hubs such as Toronto, Vancouver and Montreal have long commanded a premium multiple compared to suburban office properties due to their supply/demand imbalance. Scarcity of land and above average population growth in city centers have translated into high rental revenue per square foot as well as extremely low vacancy rates. Prior to the onset of COVID-19, vacancy rates in Downtown Toronto and Vancouver have been around 2%, whereas suburban vacancy rates have been around 9-10%, according to company reports. If the shift to WFH remains after the pandemic, downtown office vacancy rates are expected to meaningfully spike up and conversely, the cost advantage of the suburban office market could become more attractive. Tenant makeup would also dictate the impact on rent growth and vacancy rates since landlords with exposure to smaller tenants are more susceptible to payment default risks.

2. **Lease maturity:** Office REITs with large upcoming lease maturities are more exposed to WFH risks. Office leases tend to be 5-10 years in length and tenants are likely to revaluate their space requirements when their leases are approaching maturity. For Canadian office REITs, total percentage of gross leasable area ("GLA") with lease maturities over the next 2 years is in the low to mid-teens. For example, the chart below shows the lease maturity schedule for Allied Properties from 2020-2024. Allied has around 4% of GLA maturing in 2020 and 13% in 2022. Should tenants decide to not renew upon lease maturity, landlords are exposed to the risk of not being able to back-fill vacant space.

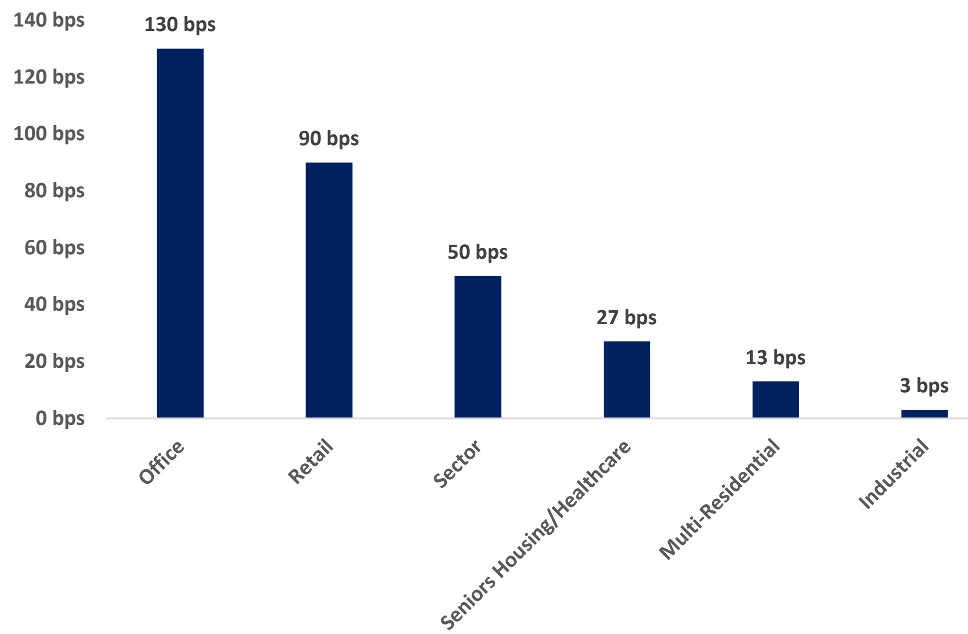


Source: Company reports, RBC, as at July 30, 2020

3. **Leasing spread:** Lease contracts typically have built-in escalators. Upon lease maturity, there is typically a high mark-to-market adjustment as expiring leases get adjusted to current rent levels. When demand decreases due to the WFH transition, leasing spreads could narrow and rental revenue could contract. For example, Allied Properties' leasing spread was 19.3% in the first half of 2020. In the second quarter, Allied Properties renewed or replaced 72% of its expiring leases at a 16% leasing spread, according to a company presentation. We also want to point out since lease terms tend to be long, the impact of work from home may not be as immediate as some investors expect since many companies will wait until their lease maturity to review their office space requirements.

4. **Capitalization rates (cap rate):** Implied capitalization rate is a measure of yield calculated as net operating income generated in the last 12 months divided by an implied real estate value based on the company's equity market capitalization and outstanding debts. The capitalization rate and property value are inversely correlated such that the capitalization rate increases when the implied real estate property value decreases. Scotiabank estimated a 50bps increase in implied cap rates year-to-date for the REIT sector as a whole and a 130bps increase for office properties, the most among the REIT subsectors.

Year-to-Date Change in Canadian REIT Sector's Implied Capitalization Rate



Source: CBRE, FactSet, Scotiabank, as at September 17, 2020

5. **Development pipeline:** Construction activities paused during March and April and have slowly come back online during the second and third quarter of 2020. Office properties are typically pre-leased prior to construction. The risk profile of future development has increased materially due to the amount of uncertainty involved with office demand. Development should be under pressure until there is more clarity around the COVID-19 outlook.

Brompton's Approach

Brompton Global Real Assets Dividend ETF ("BREA") currently has no exposure to office REITs. The fund has exposure to high quality companies in the Real Estate sector including Data Centers, Towers and Industrial REITs, which are beneficiaries of WFH trends. As the effects of WFH trends and Covid disruption continue into the coming year, Brompton will be actively assessing the opportunities within the real estate sector to maximize reward relative to risk. The fund focuses on companies with strong growth profiles and long-term secular tailwinds. We balance the risk/reward profile of the portfolio across growth, defensive and cyclical themes. The fund's weights are actively managed based on our fundamental view of each sector.

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