Investing in REITs

REITs are quickly gaining momentum as an alternative option to stay active in the real estate game because they can provide reasonable and even lower risk investment opportunities than going it alone. *Kit Kadlec* outlines what you need to consider before attempting this strategy

With improving yields, Real Estate Investment Trusts (REITs) in Canada have outperformed their American counterparts and are looking towards a bright 2010 and beyond.

In addition to their profitable performance, REITs could become increasingly prevalent in the next few years based on new legislation set for 2011.

The upsides are numerous. Investors have found good yields, a significant tax advantage and the ability to get into real estate with liquidity and avoiding much hassle. REITs certainly have paid off in the double digits of percentage growth in the recent past, but it is still something many investors haven't considered yet in Canada.

"It's a small sector of the capital market, so most people aren't aware that they exist," says Dennis Mitchell, a portfolio manager at Sentry Select. "People still like to buy stocks."

REITs are basically a mutual fund that invests in a portfolio of real estate of specific types of properties such as apartments, office, retail or hotels. Unit holders get a proportional share of profits and losses. While perhaps not as glamorous as playing the stock market or investing in individual properties, they are generally more predictable and involve significantly less work than landlording.

Mitchell says he expects Canadian REITs to show good returns in the low teens for the next few years as a total return (distributions plus capital appreciation) given growth and an improved global economy.

"With REITs yielding seven per cent, this is a pretty easy prediction to make," he says. "Also, next year will see more capital flow into REITs as income trust investors sell to avoid the impending 2011 taxation of income trusts."

Mitchell refers to the Halloween 2007 decision by the Harper Government, voting to essentially eliminate the income trust business by changing tax treatment to them, thus protecting the government's own tax intake. But REITs were excluded from this legislation.

"After 2011, real estate investment trusts are going to be the only tax-efficient savings or investment vehicles left for Canadians," says Greg Romundt, president of the Centurion Apartment REIT.

Romundt says Canadians are going to want a place to put their money to accrue interest, and there are few places that will offer what real estate can.

"With interest rates being basically zero, where do Canadians turn?" he says. "The business trusts are gone, the bank account rates are virtually zero, money market fund rates are zero, and Canadian bonds give you virtually nothing. Real estate is one of the few places that an investor can turn for tax-efficient cash flow."

Tax benefit

The tax benefit of REITs essentially relates to distribution.

A lot of the distribution from Canadian REITs is what's called return of capital. It's an accounting term that basically means you don't pay taxes on distribution.

"A portion of the distribution is classified as return of capital, and you don't pay taxes on it," says Mitchell. "It goes to reduce your adjusted cost base, so that when you go to sell the unit later, you realize more of a capital gain than you normally would have."

For example, he says if you buy a unit

at $10 and the distribution is $1, and half of that is return of capital, then after one year, your adjusted cost base would go from $10 to $9.50, because that $0.50 return of capital reduces your cost base and you don't pay taxes on it right away.

The other $0.50 is generally business income which is taxable.

"So if you were to sell the unit a year later, and let's say it's gone up to $11, you'd pay a capital gains tax on $11 minus the $9.50 cost base, so you'd have a $1.50 in capital gains as opposed to $1 in capital gains."

Owen Shaw, co-founder of the Integrity Wealth Group Bank, says the benefit is mutual to the REIT and investor.

"The REIT, due to its income nature as an income trust, flows through its cash flow earnings to its shareholders," he says. "So that operating as a trust, it doesn't have to pay any corporate income tax on revenue that's generated in the portfolio, and so that advantage for an investor is that the profits essentially become almost 100 per cent tax deferred until the time that they draw them out of the portfolio."

Thus if you're accruing gains and your dividend is in a registered account, you're not paying any personal income tax until you decide to discharge the capital from the registered account.

"So you have this opportunity to grow this capital tax-free, which gives you a tremendous edge in terms of building your portfolio," says Shaw.

That paves the way for strong growth. One private Canadian REIT, for example, boasts eight per cent annual distribution for investors, with monthly payouts. Each unit costs $10, with a minimum investment of $5,000. Investors can also borrow to boost their overall stake.

With an overall investment of $10,000 at an eight per cent distribution, monthly payments would be just under $670, and the annual total would equal $8,000. As long as your REIT has a portfolio of steady rental income, those can be reliable expectations.

Of course any real estate property requires management and repair costs, but these can be minimal in a REIT when it's all handled under one roof for a large number of properties.

No late-night phone calls from tenants

When investing in a REIT, you're essentially buying into the real estate market. But it's a much different type of investment than buying a singular property and managing it yourself.

An apartment REIT, for example, buys multiple complexes and properties throughout the country, manages them and handles the portfolio. Unlike amateur investors, the purchases for any new properties are made by professionals with experience and heavy research.

"There's a misperception about real estate investing and that perception is that it's always passive income," says Romundt. "In my experience, there's nothing passive about real estate. Absolutely nothing."

He says it's rare that non-professionals can find the best deals that will bring about the highest yields.

"You have to be continually active looking for deals, and you know what, very likely when you find them, they tend to be the stuff that professionals have already picked over, so you're getting what's left over," he says.

Also, buying an investment property

PERFORMANCE & VALUATION REVIEW																					
Basics												FFO		P / FFO		FFO	AFFO (FD)		P / AFFO		AFFO Payout Ratio
REIT	Stock / Risk Rating	Target Price	Current Price	Units Basic (mln)	Mkt Cap ($mln)	NAV	Cap Rate	Implied Cap Rate	Premium to NAV	Distrib	Current Yield	2009E	2010E	2009E	2010E	Growth '09-'10	2009E	2010E	2009E	2010E	2010E
RESIDENTIAL FOCUSED																					
Boardwalk	SP / A	40.00	36.97	52.7	1 948	35.00	6.50%	6.3%	5.6%	1.80	4.9%	2.54	2.54	14.6	14.6	0.0%	2.23	2.23	16.6	16.6	81%
CAP	SP / BA	14.50	13.09	68.6	898	13.85	6.60%	6.7%	-5.5%	1.08	8.3%	1.25	1.26	10.5	10.4	0.8%	1.07	1.08	12.2	12.1	100%
InterRent	SP / AA	1.60	1.65	28.5	45	1.50	7.55%	7.4%	6.0%	0.12	7.5%	0.09	0.10	17.7	15.9	15.6%	0.02	0.05	N/A	35.1	255%
Killam Properties (2)	OP / A	8.25	7.96	38.4	306	7.80	7.35%	7.3%	2.1%	0.56	7.0%	0.66	0.70	12.2	11.3	7.3%	0.53	0.57	15.2	13.9	98%
Lanesborough			0.57	17.5	10	N/A	N/A		N/A	-	0.0%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Mainstreet Equity (2)	OP / AA	10.60	9.00	10.4	92	11.80	7.35%	7.9%	-25.1%	-	0.0%	0.55	0.82	16.1	11.0	49.1%	0.36	0.61	24.6	14.8	N/A
Northern (1)	OP / A	23.00	21.21	25.1	532	20.00	8.35%	8.1%	6.1%	1.48	7.0%	2.17	2.15	9.8	9.9	-0.9%	1.97	1.96	10.8	10.8	76%
Parkbridge (2)	OP / AA	5.35	4.20	66.8	280	5.35	8.10%	9.5%	-21.5%	-	0.0%	0.35	0.41	11.9	10.3	15.0%	0.32	0.38	13.1	11.2	N/A
Sub-total					**4 111**		**7.4%**	**7.6%**	**-4.6%**		**4.3%**			**13.2**	**11.8**	**12.4%**			**15.4**	**16.1**	**122%**
RETAIL FOCUSED																					
Primaris	SP / ERR#	16.75	16.09	62.5	1 005	15.75	7.90%	7.8%	2.2%	1.22	7.6%	1.25	1.43	12.9	11.3	14.4%	1.06	1.17	15.2	13.8	104%
Calloway	SP / AA	18.75	18.98	99.1	1 882	16.90	7.60%	7.4%	12.3%	1.55	8.2%	1.66	1.60	11.4	11.9	-3.6%	1.56	1.49	12.2	12.7	104%
Retrocom			3.00	18.5	56	N/A	N/A		N/A	0.45	15.0%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
RioCan	SP / A	17.75	18.29	235.2	4 302	15.40	7.25%	6.5%	18.8%	1.38	7.5%	1.25	1.39	14.6	13.2	11.2%	1.11	1.26	16.5	14.5	110%
Crombie	OP / A	11.05	10.00	61.0	610	10.55	8.50%	8.7%	-5.2%	0.89	8.9%	1.04	1.25	9.6	8.0	20.2%	0.71	0.89	14.1	11.2	100%
First Capital Realty (2) *			20.16	95.9	1 934	N/A	N/A	N/A	N/A	1.28	6.3%	1.61	1.66	12.5	12.1	3.1%	1.44	1.51	14.0	13.4	85%
Scott's *			7.27	7.2	51	6.97	N/A		1.0%	0.85	12.1%	0.89	0.91	7.9	8.0	2.2%	0.88	0.88	8.0	8.3	97%
Sub-total					**9 839**		**7.8%**	**7.6%**	**5.8%**		**9.4%**			**11.5**	**10.7**	**7.9%**			**13.3**	**12.3**	**100%**
SENIORS HOUSING FOCUSED																					
Amica Mature Lifestyles (2)	OP / AA	6.50	5.20	16.4	84	6.50	8.00%	9.2%	-20.8%	0.24	4.7%	0.29	0.22	17.8	23.6	-24.1%	0.23	0.15	22.4	34.7	160%
Chartwell *			6.32	117.2	737	6.13	N/A		2.6%	0.54	8.6%	0.56	0.70	11.2	9.0	25.0%	0.66	0.62	9.5	10.2	87%
Extendicare *			7.50	73.1	553	9.93	N/A		-23.8%	1.11	14.7%	1.38	1.33	5.5	5.6	-3.6%	1.28	1.18	5.9	6.4	94%
Sub-total					**1 375**		**8.0%**	**9.2%**	**-14.0%**		**9.3%**			**11.5**	**12.8**	**-0.9%**			**12.6**	**17.1**	**114%**
HOTEL FOCUSED																					
Holloway *			0.48	39.1	19	0.90	N/A		-46.7%	-	0.0%	0.04	0.12	12.0	4.0	200.0%	0.04	0.12	12.0	4.0	0%
InnVest *			4.78	87.4	415	4.18	N/A		13.6%	0.50	10.5%	0.96	0.97	4.9	4.9	1.0%	0.64	0.68	7.4	7.0	74%
Royal Host *			2.36	19.6	47	1.80	N/A		32.8%	0.30	12.6%	0.45	0.46	5.3	5.1	2.2%	0.32	0.34	7.5	6.9	88%
Sub-total					**481**				**-0.1%**		**7.7%**			**7.4**	**4.7**	**67.8%**			**9.0**	**6.0**	**54%**
OFFICE FOCUSED																					
Allied Properties	OP / A	18.75	17.47	39.0	681	17.00	8.40%	8.2%	2.8%	1.32	7.6%	1.72	1.79	10.2	9.8	4.1%	1.43	1.51	12.2	11.6	87%
Dundee *			19.34	24.7	477	20.59	N/A		-6.1%	2.20	11.4%	2.99	2.90	6.5	6.7	-3.0%	2.14	2.17	9.0	8.9	101%
Brookfield Properties * (2)			11.83	391.3	4 375	N/A	N/A		N/A	0.56	5.0%	1.33	1.25	8.4	9.5	-6.0%	N/A	N/A	N/A	N/A	N/A
Sub-total					**5 533**		**8.4%**	**8.2%**	**-1.7%**		**8.0%**			**8.3**	**8.5**	**-1.7%**			**10.6**	**10.2**	**87%**
DIVERSIFIED																					
CREIT	SP / A	27.75	26.34	66.2	1 744	24.15	7.65%	7.2%	9.1%	1.38	5.2%	2.30	2.34	11.5	11.3	1.7%	2.02	2.07	13.0	12.7	67%
H&R *			13.23	148.1	1 960	14.81	N/A		-10.7%	0.72	5.4%	1.47	1.44	9.0	9.2	-2.0%	1.38	1.29	9.6	10.3	56%
Artis	SP / AA	10.00	9.95	37.4	372	9.00	8.25%	8.0%	10.6%	1.08	10.9%	1.46	1.39	6.8	7.2	-4.8%	1.04	1.07	9.6	9.3	101%
Cominar	OP / AA	21.00	18.29	54.7	1 000	18.75	8.10%	8.3%	-2.5%	1.44	7.9%	1.78	1.80	10.3	10.2	1.1%	1.54	1.59	11.9	11.5	91%
Huntingdon *			0.41	72.6	29	0.80	N/A		-50.0%	-	0.0%	0.13	0.15	3.1	2.7	15.4%	0.06	0.08	6.7	5.1	0%
Morguard *			11.44	58.8	672	12.93	N/A		-11.5%	0.90	7.9%	1.18	1.18	9.7	9.7	0.0%	1.01	0.98	11.3	11.7	92%
Whiterock	UP / AA	10.50	14.11	9.5	133	10.50	8.25%	7.7%	32.8%	1.68	12.1%	1.68	1.77	8.3	8.0	5.4%	1.22	1.47	11.4	9.6	115%
BTB REIT	SP / AA	0.75	0.74	33.7	25	0.72	9.25%	9.2%	4.2%	0.08	10.7%	0.13	0.15	5.8	4.9	15.4%	0.09	0.11	8.3	6.7	73%
Sub-total					**5 935**		**8.3%**	**8.1%**	**-2.3%**		**7.5%**			**8.0**	**7.9**	**4.0%**			**10.2**	**10.0**	**74%**
Total or Average					27 274		7.8%	7.9%	-2.4%		7.4%			10.3	9.6	12.1%			12.1	12.0	93%

Sources: company reports. historical & forecast FFO: First Call, NBF, Bloomberg, NAV and AFFO for companies not under are coverage based on consensus

FFO = Funds from Operations; AFFO = Adjusted Funds from Operations; P = Price Multiples

Stock Rating: OP = Outperform; SP = Sector Perform; UP = Underperform; S = Speculative; n/a - Not Applicable

Risk Rating: L = Low; A = Average; AA = Above Average; BA = Below Average; S = Speculative

*** Note that for First Capital, Scott's, Chartwell, Extendicare, Holloway, InnVest, Lanesborough, Royal Host, Dundee, Brookfield Properties, H&R, Huntingdon and Morguard, FFO, AFFO and NAV is based on consensus.**

Source: National Bank Financial

often entails managing it yourself and essentially becoming a landlord. Few people have the time or patience for that, however.

Another advantage to REITs is that the real estate industry is heavily regulated, and following all the laws can often be a bit intimidating as well.

"REITs really give you the opportunity to just sit at home and collect the cheques," says Romundt.

And most importantly for some with limited funds, REITs allow you the chance to invest with a smaller share of cash needed to buy a house or apartment. Just $5,000, for example, can get you started at some private REITs.

Finding the right REIT

But there is some work involved in finding the right REIT. Just like finding a property, you need to research and find which one is the best option for you. In addition to the countless REIT companies, there are also various REIT options, such as retail, office or apartments.

According to a survey by the Real Property Association of Canada this year, some 20 per cent of REITs were retail, 20 per cent were office, seven per cent were multi-family residential, and 37 per cent were diversified with three or more asset types.

Almost all of these REITs offer diversity of multiple locations and properties, however. That's a major advantage to an investor who wants to spread out their money.

"Unless you're exceedingly wealthy and can afford to purchase dozens or hundreds of buildings on your own, buying a single piece of property means you're undiversified," says Romundt.

Jason Castellan, CEO of the Skyline Apartment REIT, says multi-family residential is one of the safest ways to go.

"You can choose from multi-residential on the low-risk end to the higher risk REITs like hotels or your single-tenant REITs," he says. "Sure, some may offer different rates of returns, but there's also more risk attached to that. So you have to decide what your risk profile is."

For those with a higher risk profile, it's important to do enough research about the property or properties. That's especially true with a hotel REIT, says Shaw, whose company Integrity Wealth

Group offers a hotel investment already and plans to open a private residential multi-family REIT early this year.

"If you've got a good asset, and you've got good management, then your revenue and cash flow can be substantial," says Shaw. "But if you don't have the right management or right asset, just as quickly you could lose your money."

That comes down to the fact that with hospitality, you're not just buying into real estate, but also buying into the business that operates within the real estate.

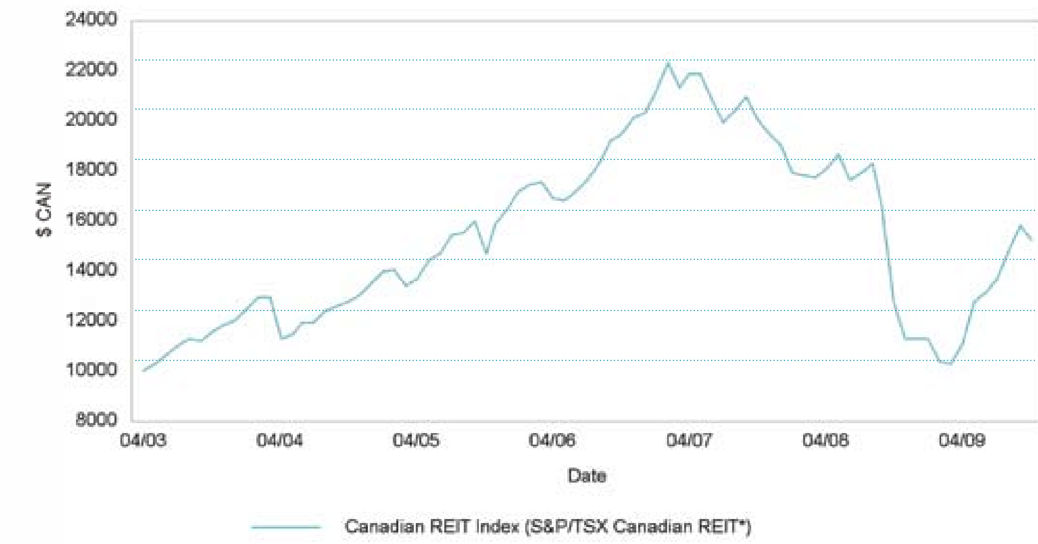
You can also examine where your REIT has properties. For example, Integrity Wealth Group plans to operate mostly in Western Canada, Skyline has stuck to mostly secondary and tertiary markets outside Toronto, and the Canadian Apartment REIT has a focus in the major centres of Canada from coast to coast.

Many funds stick near company headquarters – following the age-old rule of sticking to what you know best.

In that manner, few

Growth of $10,000

Annual values as of 31 October 2009



Canadian REITs will venture into U.S. investments either.

"I think there's good opportunities down there (in the U.S.), but that's such a huge market and it's hard to know what's the right side of the tracks and the wrong side," says Castellan of Skyline. "There are still many opportunities in our own backyard, so we don't need to go beyond that."

Others in the industry agree that it's best to stay near home. The same can be said for investing in a U.S. REIT. It's a more aggressive market with growth as the top objective, as opposed to the Canadian model of yields, says Mitchell. There's also been much more stability lately in Canada.

"2010 will be a good year for the strong, well-capitalized Canadian REITs," says Canadian Apartment REIT President and CEO Tom Schwartz. "They will have access to well-priced equity and debt at a time when a reasonable supply of accretive investment opportunities are available, leading to solid growth."

Investors should also consider the currency risk, says Romundt.

"The Canadian dollar still has substantial upside to the U.S. dollar, I believe," he says. "So investors who have bought into U.S. REITs for the last number of years have not done very well, particularly on the currency component of the trade."

Those who get into the U.S. REIT market now are essentially taking the risk that a recovery is on the horizon. Romundt says the problem with that is the differences in international markets over the years has greatly narrowed.

"There's not much benefit to be internationally diversified, particularly in a big downturn," he says. "Canadians who actually stayed home with their investments the last couple of years have significantly outperformed those who invested internationally."

No matter where you choose to buy, be sure to put as much time into choosing your REIT as you would any piece of property. You may even decide to buy more than one REIT to diversify your holdings there even more, but each one should be carefully researched, says Romundt. Many REITs post examples and private returns on their websites. Past history often can give you the best gauge of future performance.

Public versus Private

Investors also need to make an important decision regarding whether to go with a private or public REIT. The differences are significant.

Shaw, in deciding to go forward with creating his company's REIT this year, decided to go with the private side.

"With public REITs, it's not so much the value of the portfolio that determines the share price, it's the emotions of the market," he says.

Investors in public REITs have to deal with those shifts in sentiments, which can be hard to predict. Basically, by going private, you can eliminate some of the volatility.

"I want the diversification that real estate offers, so I want to be out of the stock market," says Romundt. "Buying a publically listed REIT gives me that stock market risk back. So if I want a pure play in real estate, I want a private REIT."

The ICREIM/IPD Canada Annual Property Index says non-listed REITs returned just 3.7 per cent in 2008, but listed ones on the S&P/TSX REIT index dropped 34 per cent. It was a bad year all around, although the listed REITs result was consistent with the broader TSX performance in the same year (down 36 per cent). It was much better on the private side, and private REITs can also have lesser costs of operation and management of a portfolio.

But there are points to be made on the other side as well. Public REITs have strict reporting rules that they most follow, and thus are required to be more open. Private companies, due to their nature, aren't required to report in the same manner to their investors.

There's also more liquidity in the public sector. You can just put in a sell order and trade it immediately to whoever is willing to match the bid price on an exchange.

"With a private REIT situation, generally speaking, you send notice to the company and then they would try to redeem your shares at some point in time over the course of the calendar year or fiscal year," says Shaw. "Some REITs do it quarterly, some do it annually."

Shaw adds, however, if you have a well-managed investment, there's little reason why you would be looking for liquidity anyway. A good REIT can be a long-term investment.

Public REITs will also have a lesser investment cost, as private REITs can have a minimum of at least $10,000.

Whatever you choose, make sure you're comfortable with the style of management and portfolio in your REIT.

"It doesn't really matter as much if it's private or public," says Shaw. "You need to look for management that has a track record, that has experience, and then look for a long-standing history of transparency."

Public REITs VS Private REITs

	Public REITs	Private REITs
Liquidity	Can be sold as soon as a matching bid is found	You can't just call your broker and sell the same day. Much slower process.
Volatility	Similar to stocks, can shift with varied market sentiment	Like investing in a real piece of property, slower moving
Minimum investment	One share	As little as $5,000
Corporate governance	Must follow specific stock exchange rules	Not required
Disclosure requirement	Must make public financial disclosures	Not required

All REITs need to consider how they will manage their debt. That's something Shaw considers a double-edged sword. Leveraging your equity can increase yields, however it can also put your fund at risk if you leverage too much. Don't leverage enough and you'll end up wasting potential future growth.

Integrity Wealth Group will try to maintain a leverage balance of about 70 per cent, for example.

"If the market were to turn, the fund still has relatively decent liquidity," he says.

Looking ahead

Like other markets, Canadian REITs struggled through the financial crisis. But they've come out clearly better than their U.S. counterparts. Some, like Romundt, see that continuing through 2010 with strong yields behind it.

"Give Canada's positive resource position and our low debt, there's a positive Canadian story here," he says. "I think Canada's going to outperform (the U.S.) for a number of years, and not only on the rewards side, but with substantially less risk. The U.S. is still in a very difficult position, and they're incurring a tremendous amount of debt."

Mitchell agrees that investors can expect good things ahead, even if they missed some of the already strong gains of 2009. There's still a recovery happening from last year, he says.

"For something that's often used as a steady source of income, you're still looking at double-digit returns," he says of Canadian REITs.

Timing shouldn't matter too much in the big picture, however.

"If you're looking for long-term stability and growth, investing in REITs anytime is good because that's kind of the mandate of REITs," he says. "We're not flippers. We're here to buy and hold. And as long as people need housing, one of the basic needs, we're going to be able to provide that."