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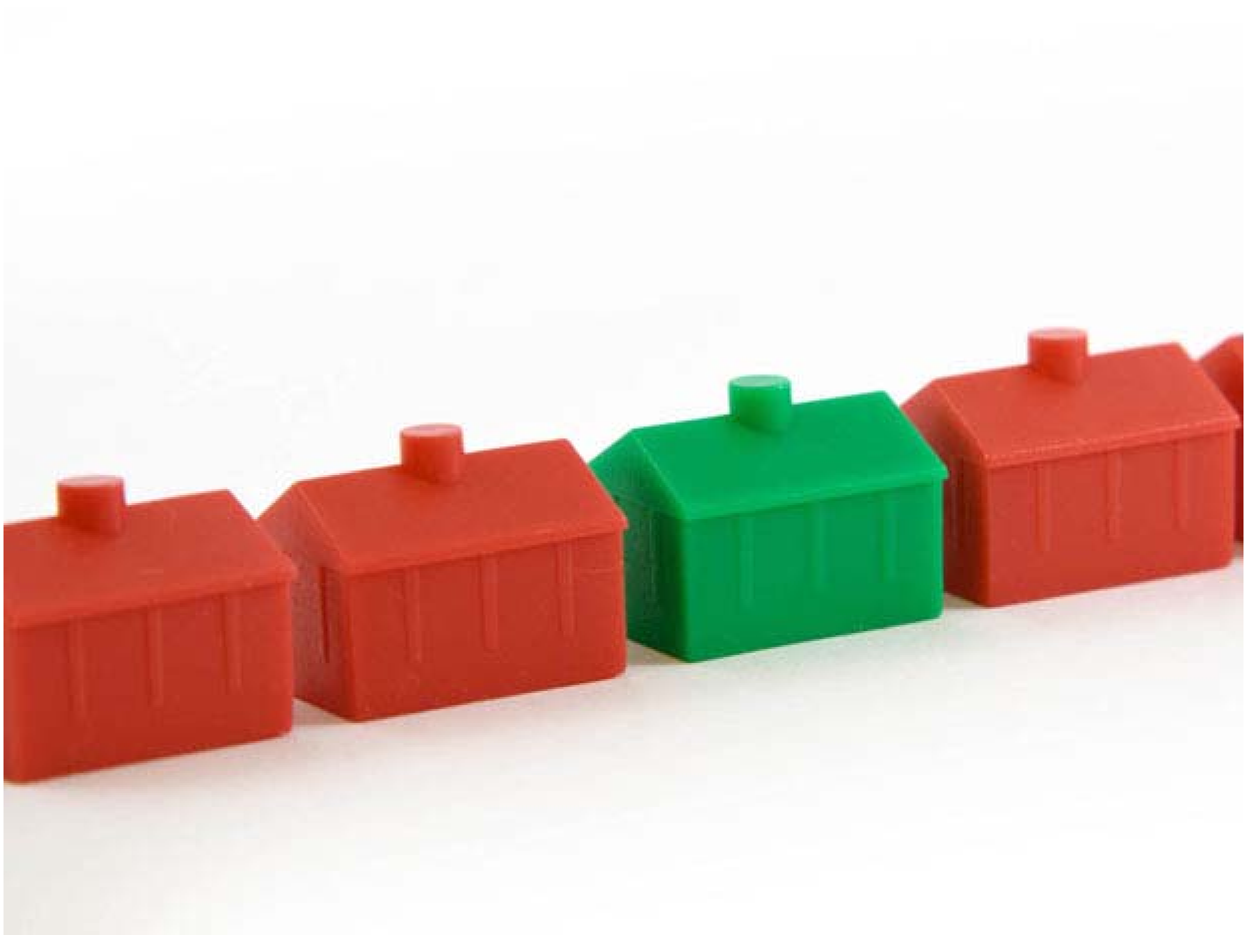
Rental income, tax breaks give REITs stability

Eric Lam Oct 5, 2011 – 4:55 PM ET



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As a very wise man once said (I think it was Lex Luthor) stocks may rise and fall, companies may come and go, but people will always need land and real estate.

Now, trying to blow up the West Coast isn't an option as Superman would just get in the way. But there is a much less explosive option to get into the Canadian real estate market that does not involve buying a house: Real Estate Investment Trusts (REITs).

“With all the volatility, a lot of people are looking for safe asset classes to park their cash. And to my eye, commercial real estate is one of the only ones available,” John Andrew, a real estate professor with Queen’s University, said Wednesday. “Commercial real estate has been very stable.”

REITs are trusts that invest in and own various properties, such as shopping malls, office buildings, warehouses and rental apartments, and make money by charging rent. Since REITs are trusts, they are not charged corporate taxes and by definition must pay 90% of their profits back to investors as distributions.

The Canadian government actually got rid of this loophole for the larger corporate community back in 2006, resulting in hundreds of regular trusts converting to corporations when the new laws came into effect at the beginning of this year. However, REITs were spared.

Investors do pay income tax on the distributions, but as the REITs themselves are not taxed the gross payouts start out higher, Mr. Andrew said.

“At the moment, [distribution] yields are close to 6%, three times what you would get for a government of Canada bond,” he said.

Shares of REITs, which are publicly traded on the Toronto Stock Exchange, have held up remarkably well during the market malaise of the past few months as the Canadian real estate market has become one of the only bright spots in an otherwise dreadful summer for the economy.

This is largely due to Canada’s much-ballyhooed conservative banking rules, which kept lending down, especially to the development community. This held the supply of commercial buildings in check, which also helped to maintain demand, Mr. Andrew said.

Tenant leases, especially on commercial properties, also tend to be long-term. With the average commmercial lease running anywhere from five to 10 years, this offers a lot of very steady income sources.

“Unless the company goes bankrupt, it is very difficult to get out of a lease. And we’re not seeing any real dramatic headwinds in Canada,” he said.

REITs are also selling close to their net asset values, which suggests they are not an expensive buy, he said.

The iShares Capped REIT Index Fund (TSX:XRE) is an exchange-traded fund that tracks the S&P/TSX Capped REIT Index, and is actually up about 4.5% so far this year. The fund is the largest REIT ETF in Canada with almost $1.2-billion in net asset value across 13 holdings and management fees of 0.55%.

The fund’s largest holding by far is 25% in RioCan REIT (TSX:REI.UN), which specializes in retail properties and is the biggest REIT in Canada. Year-to-date, the trust is up 13.4% on the TSX.

Retail REITs have gotten a boost recently as foreign competitors such as U.S. retailer Target Corp., British clothing store TopShop and others begin to enter the Canadian market.

Multi-residential REITs have also benefited from rapidly inflating home prices, especially in Toronto and Vancouver, which are pushing younger families and individuals to rent instead.

However, there might not be as much capital upside in REITs as other equities, largely because they have not fallen as much in the current market selloff, Allan Small, senior investment advisor with DundeeWealth said from Toronto.

“From a stability standpoint, investors may have done a lot better in the REIT space, but what REITs may struggle with is the other side, the growth aspect,” he said. “When markets rebound, you can get not only a dividend but capital gains on top of that. There’s more potential there for the average investor than in REITs, which are good for steady income but not as much growth.”

Also, some of Mr. Small’s clients have shied away from REITs because they are unfamiliar with the names.

“Outside of RioCan, which many people know because they see the name when they go shopping, a lot of them are unknown so they’d rather go with a bank,” he said.

Mr. Small highlights Dundee REIT (D.UN:TSX), which leases office and industrial properties and pays a 7% yield as one of the REITs he buys.