CANADA

Apartment REIT vs Condo - Part III

REITs win!

Event

This morning Royal LePage released its Housing Price Survey, leading us to revisit our April 2011 analysis comparing the merits of an investment in an apartment REIT to an investment in a condominium rental property.

Our method

We compared the total returns of a Calgary condo to Boardwalk and a Toronto condo to CAP REIT (both are the most comparable). We looked at four separate periods as well as the returns of an equally-weighted REIT portfolio (Boardwalk and CAP REIT) to an equally weighted condo portfolio (Calgary and Toronto).

Results

Similar to last April's results, the apartment REIT investment outperformed a condo investment in both Calgary and Toronto. Indeed, the apartment REIT investment dominated condo investment across every holding period we looked at (Fig 1).

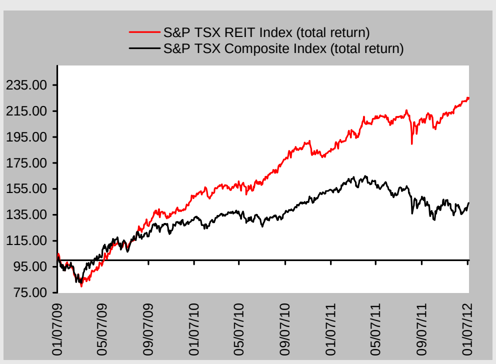
Fig 1 Condo returns vs apartment REITs

	Toronto		Calgary		Equal weighted portfolio	
Holding period	Condo (1)	CAP REIT	Condo	Boardwalk	Condo	REITs
2008 - 2011 (4 yrs)	35.3%	**66.1%**	-34.0%	**30.5%**	0.7%	**48.3%**
2009 - 2011 (3 yrs)	44.7%	**62.3%**	-6.7%	**120.4%**	19.0%	**91.4%**
2010 - 2011 (2 yrs)	26.5%	**74.0%**	-0.9%	**47.2%**	12.8%	**60.6%**
2011 (1 yr)	12.4%	**36.5%**	6.1%	**26.5%**	9.2%	**31.5%**

1)This represents the change in equity investment of the condo unit assuming 60% LTV

Source: Royal LePage, CMHC, Bloomberg, Macquarie Research, January 2012

S&P TSX Capped REIT Index vs. S&P TSX Composite Index (Total Return)



Source: Bloomberg, Macquarie Research, January 2012

Apartment REITs likely to continue outperforming

One reason is because we believe a housing correction is probable, especially in Toronto. We have seen numerous banks and government agencies state their concerns. In fact, earlier this week, the front page of the Globe & Mail's Report on Business noted that "*Canada's housing market is showing signs of peaking…the market should inevitably cool in 2012 as the supply begins to outstrip demand, and consumer debt hovers at historic high levels*".

A correction in the housing market would be good for the apartment rental market because, after all, who wants to buy a house or condo if it looks like it will decline in value. Consequently, home/condo purchases would be delayed thereby putting upwards pressure on apartment occupancy and rents as tenants stay longer. This is what is occurring in the US and the main reason why U.S. apartment REITs have done so well. There are other tailwinds for apartment REITs including favourable revenue trends, a mild winter and low natural gas prices.

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12 January 2012
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Global Property Coordinator

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Apartment REITs vs Condo


Macquarie Equities Research

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Apartment REITs vs Condo

Which is the better investment?

Asia Pacific 2012 Outlook


Macquarie Equities Research

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Turnkey 2012 Outlook

One step ahead

Global Top Picks

- Boardwalk REIT
- American Tower
- CFS Retail Property
- Esprit
- Kenedix Realty
- CapitaLand
- Capital Property Fund
- DLF

Our method

In our analysis, we compare the total return of Boardwalk and CAP REIT units (distribution yield plus capital appreciation / equity investment) to the total return of a two-bedroom, 900 sq ft condo unit in Calgary and Toronto respectively (annual rental income plus appreciation / equity investment). We evaluate the returns of each individual investment over four separate periods, as well as compare the returns of an equally weighted REIT portfolio (Boardwalk and CAP REIT) to a condo portfolio (one in Calgary and one in Toronto).

Condo prices

Condo prices and rents are established using recurring market research reports to ensure an "apples to apples" comparison. Also, since the REITs utilize 50–60% leverage, we assume condo units will be purchased with a 60% mortgage and 40% equity contribution to allow for a leverage neutral comparison. For the purposes of this exercise, we further assume a five-year fixed rate interest only mortgage. We adjust the rates to reflect the prevailing market interest rate at the time of acquisition.

Fig 2 Condominium assumptions

General Assumptions	
Square Footage	900 Sq. Ft.
Equity	40%
Mortgage	60%
Condo Fees PSF	$0.45
2011 Mtg rate	3.00%
2010 Mtg rate	4.25%
2009 Mtg rate	5.00%
2008 Mtg rate	5.85%

Source: Bloomberg, Royal LePage, Macquarie Research, January 2012

Income

For the REITs, we use the actual distributions paid during the investment period. For the condominiums, we use the average monthly rental rate of a two bedroom condo, as per CMHC's fall Rental Market Report for Calgary and Toronto from 2007 to 2011. We then deduct mortgage interest expense, condo fees and property taxes as seen in Fig 2.

Capital Appreciation

We compare the price of an average "standard condominium apartment"[1] using the 4Q survey published by Royal LePage and compare that to the prevailing unit price of the REITs at the assumed sale date. On occasion (such as this year), revisions to the House Price Survey are made to reflect new neighbourhoods. As such, we reflected the revised numbers in the historical calculations although the impact was negligible.

Leverage

When purchasing a condo, we acknowledge that some individual investors will limit their equity investment to the lowest amount possible thereby potentially generating a very high return on equity if the condo increases in value (after all doesn't real estate always go up in value?). However we don't think it is fair to compare a highly levered condo investment with an investment in a REIT that has only modest leverage. For those individual investors determined to buy a condo with, say, a 20% down payment or less, the more appropriate comparison is to assume that the investment in REIT units are purchased partially on margin. In doing so the outcome would be the same as our current analysis. In fact, the higher use of leverage would amplify the results, making REITs even more attractive. Notably, the higher debt component would also create negative cashflows for the condo investor but not for the REIT investor.

[1] Royal LePage defines a standard condominium apartment as: A two-bedroom unit with a living room, a dining room (possibly combined) and a kitchen, in a high rise building with an inside floor area of 900 sq ft. Amenities include a standard broadloom, 1 ½ bathrooms, 2 appliances, a small balcony and one underground parking space. Common area includes pool and some minor recreational facilities.

Calgary

If an investor purchased a standard condo as an investment with a four-year holding period from January 2008 to December 2011 (while achieving average market rents as reported by CMHC), the investor would have realized a 34% decline in equity value. In contrast, had the same investor purchased units of Boardwalk REIT, the investor would be up 30.5% – an absolute difference of 64.5%. As seen in Fig 3, Boardwalk outperformed the condo investment over each holding period. That said, we highlight that both the stock market and condo market experienced sharp losses in 2008 (Calgary condo: -25% (ROE), Boardwalk: -39%). Had both investments been sold in 4Q08 (12-month hold), the condo investment would have outperformed by ~14%. That said, one should not lose sight of the fact that the stable yield from Boardwalk versus negative cashflow from the condo makes holding the REIT much more tolerable in a down market. Those that did hold were rewarded with an outsized rebound the following year—52% total return in 2009 for Boardwalk versus a flat year for the condo investment. The Calgary condo market demonstrates how investors can be susceptible to market volatility, which can be further compounded by a lack of liquidity when it's needed most.

Fig 3 Calgary condo vs Boardwalk REIT

Calgary Condo				
Investment period	2008 - 2011	2009 - 2011	2010-2011	2011
Mortgage rate	5.85%	5.00%	4.25%	3.00%
Average Purchase Price:	$284,144	$257,189	$256,056	$248,344
4Q 2011 Sales Price:	$248,567	$248,567	$248,567	$248,567
	-12.5%	-3.4%	-2.9%	0.1%
Net Rental Income				
2008	-$1,898			
2009	-$828	$124		
2010	-$617	$334	$2,827	
2011	$328	$1,280	$3,772	$5,831
Total Rental Income	-$3,016	$1,738	$6,599	$5,831
Capital Appreciation	-$35,577	-$8,622	-$7,489	$223
Total Gains (Losses)	-$38,593	-$6,884	-$890	$6,054
Original Equity Investment	$113,658	$102,876	$102,422	$99,338
Total Return	**-34.0%**	**-6.7%**	**-0.9%**	**6.1%**

Boardwalk REIT				
Returns for:	2008 - 2011	2009 - 2011	2010-2011	2011
Purchase Price (Dec 31 prev yr)	$44.55	$25.56	$37.05	$41.30
Sale Price: Dec. 30 2011	$50.44	$50.44	$50.44	$50.44
Capital Appreciation (Loss) - (%):	13.22%	97.34%	36.14%	22.13%
Distributions				
2008	$1.80			
2009	$1.80	$1.80		
2010	$2.30	$2.30	$2.30	
2011	$1.80	$1.80	$1.80	$1.80
Total Income	$7.70	$5.90	$4.10	$1.80
Capital Appreciation ($)	$5.89	$24.88	$13.39	$9.14
Total Gain (Loss)	$13.59	$30.78	$17.49	$10.94
Total Return	**30.5%**	**120.4%**	**47.2%**	**26.5%**

Source: Bloomberg, CMHC, Royal LePage, Macquarie Research, January 2012

Toronto

While the Toronto condo market has performed well in recent years, returns have been primarily from capital appreciation. That being said, CAP REIT outperformed a condo investment across every holding period while generating stable monthly taxed advantaged income. For example, if a condo was held from January 2008 to December 2011, the investor would have realized an aggregate net rent income of $2,481 against an initial equity investment of ~$122k (approximately 2.0% income return). On the other hand, had the same investor purchased $122k of CAP REIT the investor would have received $33k or ~27% income return.

Fig 4 Toronto condo vs Canadian Apartment Properties REIT

Toronto Condo				
Investment period	2008 - 2011	2009 - 2011	2010-2011	2011
Mortgage rate	5.85%	5.00%	4.25%	3.00%
Average Purchase Price:	$306,830	$300,722	$319,300	$336,388
4Q 2011 Sales Price:	$347,659	$347,659	$347,659	$347,659
	13.3%	15.6%	8.9%	3.4%
Net Rental Income				
2008	$890			
2009	$1,373	$3,121		
2010	-$438	$1,310	$2,190	
2011	$656	$2,404	$3,284	$5,371
Total Rental Income	$2,481	$6,835	$5,474	$5,371
Capital Appreciation	$40,829	$46,937	$28,359	$11,271
Total Gains (Losses)	$43,310	$53,772	$33,833	$16,642
Original Equity Investment	$122,732	$120,289	$127,720	$134,555
Total Return	**35.3%**	**44.7%**	**26.5%**	**12.4%**

Cap REIT				
Returns for:	2008 - 2011	2009 - 2011	2010-2011	2011
Purchase Price (Dec 31 prev yr)	$16.03	$15.74	$14.06	$17.14
Sale Price: Dec. 30 2011	$22.31	$22.31	$22.31	$22.31
Capital Appreciation (Loss) - (%):	39.18%	41.74%	58.68%	30.16%
Distributions				
2008	$1.08			
2009	$1.08	$1.08		
2010	$1.08	$1.08	$1.08	
2011	$1.08	$1.08	$1.08	$1.08
Total Income	$4.32	$3.24	$2.16	$1.08
Capital Appreciation ($)	$6.28	$6.57	$8.25	$5.17
Total Gain (Loss)	$10.60	$9.81	$10.41	$6.25
Total Return	**66.1%**	**62.3%**	**74.0%**	**36.5%**

Source: Bloomberg, CMHC, Royal LePage, Macquarie Research, January 2012

Other considerations

__REIT investors can probably sleep a little easier at night without having to worry about carrying another mortgage, the odd bad tenant or the daily news flow of an impending condo price correction__

In addition to higher returns, we contend that REITs offer greater liquidity and diversification through a portfolio of professionally managed assets as opposed to a stand-alone property. Likewise, we think an equally important point to consider is that REIT investors can probably sleep a little easier at night without having to worry about carrying another mortgage, the odd bad tenant or the daily news flow of an impending condo price correction. Additionally, for the purposes of this exercise we did not consider:

1) Transaction costs – significant for condo investments but only minor for REITs
2) Principal payments – this hurts condo cashflows and increases the equity portion thereby lowering returns
3) Reinvestment income that would benefit REITs over condos
4) Personal time – selecting and maintaining a condo is far more time-intensive than maintaining a REIT investment
5) Repairs and maintenance that are not covered by condo fees
6) Tax considerations – both investments have pros/cons depending on the investor's circumstances
7) Downtime/lease-up fees – this can be a significant drag on a condo investment but they are not an issue for the apartment REIT

Although purchasing hard real estate assets usually has a positive emotional aspect to it, the fact is REITs outperformed condominium investments in both Calgary and Toronto in every period we looked at. What's more, had we included the numerous costs noted above, we think apartment REITs would look even more attractive.

Going forward we see more upside in REITs versus condos

"__More units are going to be listed for sale and that's going to inevitably slow down price appreciation, particularly in the condominium market"__

Going forward, we think apartment REITs will continue to outperform given our view that a condo correction is probable as opposed to the positive tailwinds in the apartment REIT space. Over the past few weeks we have seen numerous banks and government entities state their concerns. Indeed, the **Bank of Canada recently stated** "*Certain areas of the national housing market may be more vulnerable to price declines, particularly the multiple-unit segment of the market, which is showing signs of disequilibrium: the supply of completed but unoccupied condominiums is elevated, which suggests a heightened risk of a correction in this market*". Similarly, **CMHC reinforced the message saying "***More units are going to be listed for sale and that's going to inevitably slow down price appreciation, particularly in the condominium market*".

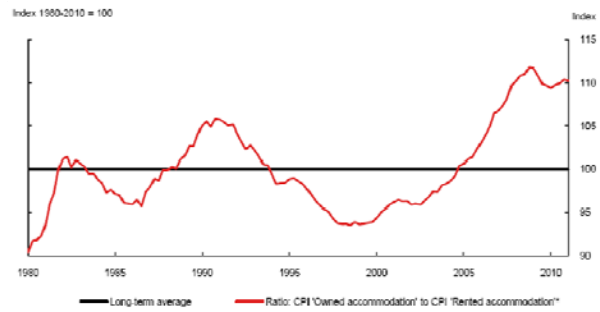
We believe that a correction in the housing market would be good for the apartment rental market because, after all, who wants to buy a house or condo if it looks like it will go down in price. In such an environment, home purchases would be delayed and there would be upwards pressure on occupancy and rents—***all of this, needless to say, is good for apartment REITs.*** While we acknowledge that apartment REITs will not be immune to choppy equity markets, we believe both operating and macro fundamentals, as detailed on the following page, support our investment thesis.

Three drivers for apartment REITs in 2012

The cost of owning a home not only exceeds the cost of renting but is near all-time highs

First, underlying fundamentals are strong as apartments offer a low-cost substitute for increasing home prices in many of Canada's urban markets. The cost of owning a home not only exceeds the cost of renting but is near all-time highs**.** With interest rates more or less at record lows this is somewhat surprising. In addition, the Bank of Canada reported that debt-to-income of Canadian households is 153%, an all-time high and above the peak ratios in US the UK pre financial crisis. Consequently, it is not too hard to imagine the Canadian housing market making a correction if interest rates start to rise. Moreover, we think that depressed home prices south of the border make high consumer debt levels and low affordability in Canada that much worse.

Fig 5 Cost of owning versus renting: near an all-time high



Source: Bank of Canada, Macquarie Research, January 2012

In the event of a housing correction, we anticipate further demand for rentals as prospective owners stay on the sidelines for longer

Along with high housing prices and household debt, it's hard to ignore the daily news flow of an impending housing price correction and we think prospective homeowners will continue to rent for longer as future expectations shake their confidence about making a purchase. In the event of a correction, we anticipate further demand for rentals as prospective owners stay on the sidelines for longer. We have seen evidence of this behaviour in many US markets where apartment rents are actually at a premium relative to all-in mortgage costs. Ongoing concerns about the US housing market and job security has resulted in a shift from homeownership to rental demand.

In a down market apartments see strong demand as people exit homeownership and condo rentals

Second, we see the sector as a defensive play with solid growth prospects in the face of economic uncertainly. First and foremost, apartment rentals provide the lowest cost housing option. As previously mentioned, in a down market apartments see strong demand as people exit home ownership and condo rentals. Another defensive characteristic is the one-year lease term, which allows landlords to adjust for inflation as opposed to long-term contracted rental rates. For growth prospects, government regulation (rent control) such as Ontario's 3.1% rent increase guideline for 2012 (substantially higher than 2011's 0.7%) will provide growth in an uncertain economic environment. The jump is a catch up to compensate landlords for higher costs associated with the implementation of HST in 2010. Since these costs are already baked into the 2011 numbers, the 3.1% increase in 2012 should be positive for NOI growth. In Western Canada, we started to see rising rental rates in 3Q11, which we think will continue this year. Since 2001, growth in the energy and resource sectors has led to above-average GDP growth, job growth, income relative to the rest of Canada. We think this is likely to continue over the long term, leading to sustained population growth, which will put upward pressure on rental rates. Halifax is another market we highlight as a result of the local economy benefitting from the $25bn Irving Shipbuilding contract. While it's difficult to quantify the economic benefit, it has been suggested that the impact will be equivalent to hosting an Olympics every year. The long-term nature of the contract (20–30 years) should lead to population growth and provide a tailwind for rental rates.

Third, there have been a limited number of purpose built apartment rental units developed since the 1970s, allowing the sector to maintain a favourable supply – demand balance. This, along with a constantly growing population supports our positive outlook on rents, occupancy and SSNOI growth. According to CBRE, multi-residential vacancy is 2.7% across the country and with little new supply coming to market; we think favourable migration and immigration patterns will favour population growth in Western Canada, GTA and Halifax which will benefit Boardwalk REIT, CAP REIT and Killam Properties.

Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

Macquarie – Asia/Europe
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie First South - South Africa
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie - Canada
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return >5% below benchmark return

Macquarie - USA
Outperform (Buy) – return >5% in excess of Russell 3000 index return
Neutral (Hold) – return within 5% of Russell 3000 index return
Underperform (Sell)– return >5% below Russell 3000 index return

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to Australian/NZ/Canada stocks only

Recommendations – 12 months
Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 31 December 2011

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	56.59%	65.60%	54.55%	44.53%	75.28%	49.46%	(for US coverage by MCUSA, 10.53% of stocks covered are investment banking clients)
Neutral	33.45%	20.55%	38.96%	50.20%	22.47%	32.36%	(for US coverage by MCUSA, 10.96% of stocks covered are investment banking clients)
Underperform	9.96%	13.85%	6.49%	5.27%	2.25%	18.18%	(for US coverage by MCUSA, 0.44% of stocks covered are investment banking clients)

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