



REITS – THE OVERLOOKED ASSET CLASS

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Jacob Fugger “The Rich” lived in the 16th century in what was then the Holy Roman Empire. He earned his nickname by expanding his father’s modest trading business across the empire and becoming one of the richest people of all time. His advice for building wealth still rings true today, “Divide your fortune into four equal parts: stocks, real estate, bonds and gold coins.”

Unfortunately, Canadian investors have largely ignored this advice, especially when it comes to the real estate component. The Canadian capital markets provide retail investors ample exposure to stocks, bonds and commodities, but little exposure to investment-grade commercial real estate. Publicly traded real estate only accounts for approximately 3% of the Canadian capital markets and thus, is often overlooked when investors allocate capital.

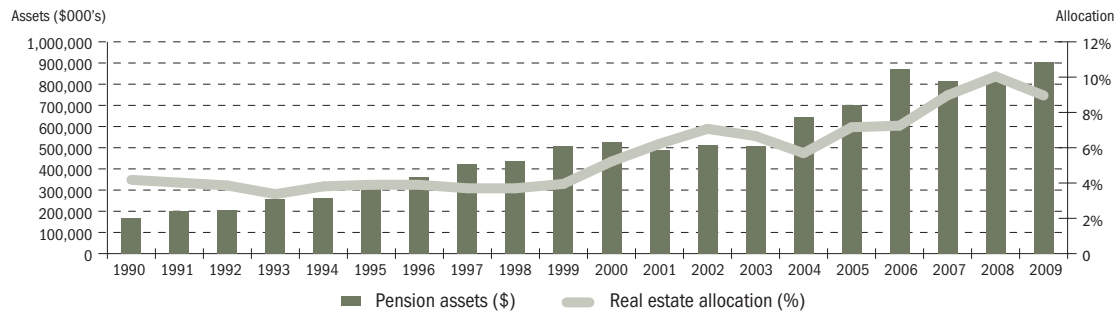
The S&P/TSX 60 Index is the template and benchmark for many Canadian equity mutual funds. This index provides less than 1% exposure to real estate, spread across two companies – Brookfield Asset Management Inc. and Fortis Inc. So while many Canadian investors can claim to get sufficient exposure to the materials, financials, energy, industrials, consumer staples and telecom sectors by purchasing an index or Canadian equity mutual fund, the same cannot be said for their real estate allocation. In this regard, most Canadian investors are on their own.

Many retail investors believe that their family home or cottage provides sufficient exposure to real estate. However, most Canadian investors do not treat their home as an investable asset: buying and selling based on the outlook for capital appreciation. Moreover, recent history in the U.S. residential housing market tells us that treating homes like investible assets can have catastrophic consequences for investors and their families. Some investors may have taken the added step of acquiring a portfolio of income-generating real estate directly. However, these investments often pale in comparison to what is available through real estate investment trusts (REITs).

REITs provide access to internationally diversified portfolios of investment-grade commercial real estate managed by some of the best professionals in the industry. The returns are typically differentiated from those of residential real estate as commercial real estate is more diversified, and tied to various business and economic cycles. Compared to a small portfolio of local real estate, REITs offer better diversification and liquidity without the responsibilities of day-to-day management. Still, it’s easy to question whether it’s even worth investing in real estate, at 3% of the capital markets. Shouldn’t investors focus on getting the calls right in the ‘big 3’ sectors: materials, energy and financials?

Pension plans show the way

We're not arguing that those aren't important sectors to allocate capital to, but it should be noted that Canadian pension plans seem quite inclined to invest in commercial real estate. Pension plans have long-term liabilities to beneficiaries that must be settled in cash. That makes real estate investments a natural choice for these plans. Real estate assets are long term in nature, and generate significant and recurring cash flow that matches the liability profile of the pension plans. The top 100 pension plans in Canada control over \$900 billion in assets and in 2009, over \$81 billion or 9.0% was invested in real estate assets. This percentage has more than doubled over the last 20 years as Canadian pension plans have begun concentrating their investments in cash-flowing assets.



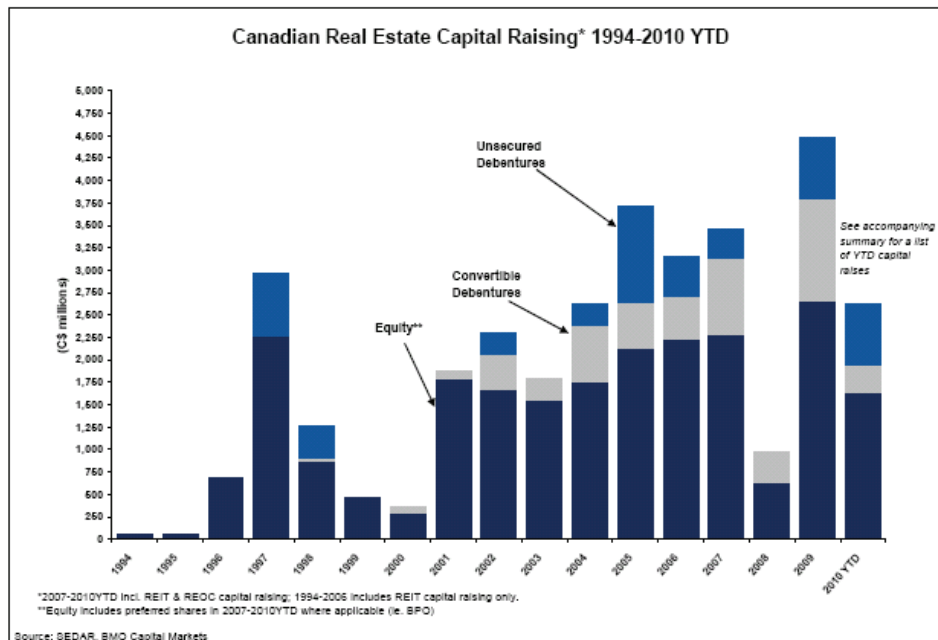
Source: PIAC

REITs largely exempt from trust tax

More recently, Canadian retail investors have begun to allocate more capital into real estate mutual funds and REITs. Much of this is in response to the Tax Fairness Plan and its implementation through Bill C-52. On January 1, 2011, all business, infrastructure, and oil and gas royalty trusts will become taxable in the same manner as corporations. And while their distributions will be eligible for the dividend tax credit, many have already converted to corporations and slashed their distributions in response. REITs, as the globally recognized vehicle for real estate ownership in the public markets, were largely exempted, so their tax-free status will continue.

There are approximately 30 countries globally that have REIT or REIT-like legislation in place, including the U.S., the U.K., Germany, France, Japan, Australia and Hong Kong. And the ranks are swelling with China, Brazil and India at varying stages of creating and passing REIT-like legislation. So while other trust sectors in Canada have shed assets, REITs continue to attract capital and the likelihood of an 11th hour amendment to the REIT exclusion is highly unlikely. Indeed, this year alone, Canadian real estate issuers have raised over \$2.5 billion in capital, following on the heels of over \$4.2 billion in capital raised last year. This year also saw the return of IPOs to the real estate sector, with four successful new launches.

But the trust tax deadline is not the only catalyst driving investors into REITs. As the population of Canada ages, investors naturally transition from investing for growth to investing for income. The flow of capital into income securities has pushed long-term GIC and treasury yields well below 4%. Increasingly, to meet their income needs, Canadian investors have turned to Canadian REITs. Given the tax-efficient nature of the distributions, 6%+ cash yields and the monthly payment frequency, this trend is likely to continue or even accelerate.

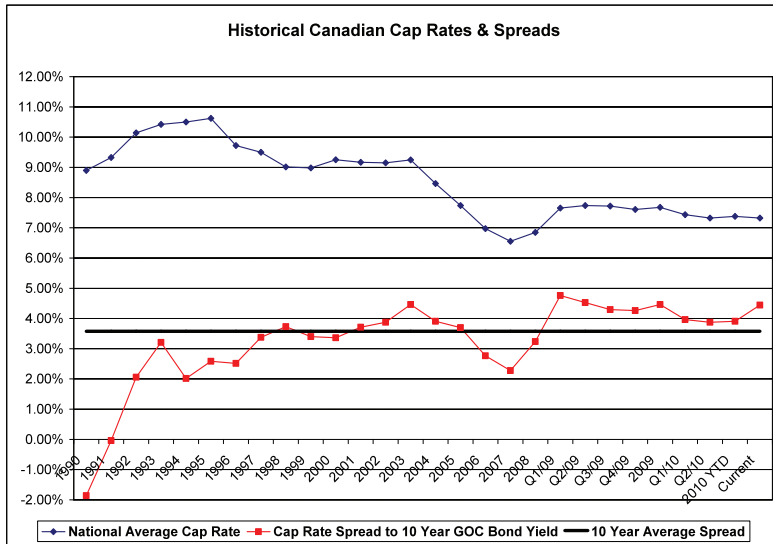


Benefiting from a low-interest-rate environment

REITs are low-growth investments, generally delivering the bulk of their returns in the form of higher yields. After delivering 42% total returns in 2009 and 19% year to date, investors are questioning whether there is still upside in the sector. Of course, our answer is biased but we note that Canadian REITs are still 26% below their peak levels in February 2007. Since then, interest rates have come down, occupancies have recovered and Canadian REITs have weathered the “Great Recession” with little real damage to show for it. We still see significant potential upside in Canadian REITs based on internal growth (debt refinancing), external growth (acquisitions), market conditions (low equity market returns) and strong fund flows over the next several years.

REITs are reaping significant benefits from the current low-interest-rate environment. As rates have come down so have discount rates used to value investments. Lower discount rates mean higher valuations – think bonds, lower yields mean higher prices and vice versa – and we see significant potential for lower discount rates and higher valuations in the Canadian REIT space. For REITs, the discount rate is called a capitalization rate or ‘cap rate.’ CB Richard Ellis produces a cap rate survey every quarter and pegs commercial real estate cap rates by sector, based on actual real estate transactions completed in the quarter. Canadian real estate is currently trading at an implied aggregate cap rate of 7.32%. With benchmark bond yields hovering around 2.88%, the spread between real estate cap rates and bond yields is approximately 444 basis point (bps). The 10-year average spread is 358 bps, meaning Canadian real estate cap rates have room to decline further, which would push real estate values up.

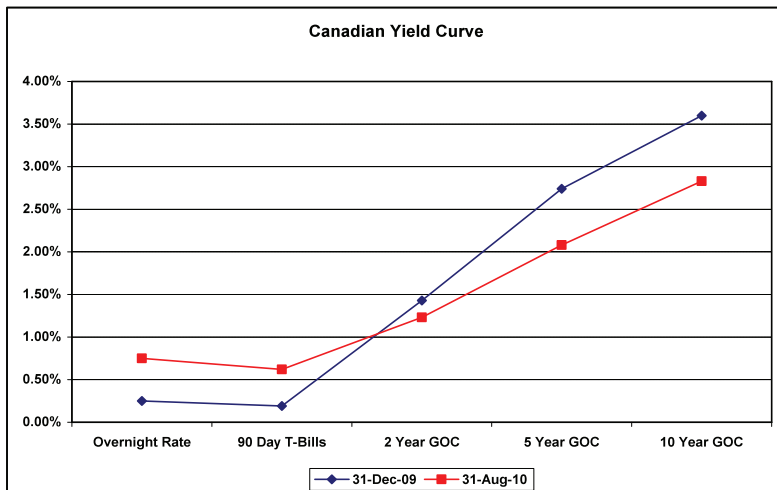
To get down to historical spreads, cap rates would have to decline 87 bps or 24%, giving Canadian REITs significant upside appreciation potential, even after recent returns. According to CIBC’s real estate research team, Canadian REITs have anywhere from 10% to 37% upside to current net asset values if cap rates were to compress by 50 bps. An 87 bps decline in cap rates would have an even more meaningful impact on net asset values and target prices.



Source: BMO Nesbitt Burns

Now there is more than one way for a spread to tighten. One could argue that bond yields could also rise, shrinking the spread between cap rates and bond yields. However, inflation is benign right now and most economists are reducing their growth forecasts for both Canada and the U.S. for 2010. And with capital flowing into bonds and yield securities in unprecedented volumes, it is highly unlikely that bond yields will rise any time soon. Even the U.S. Federal Reserve has gone on record saying that it intends to allocate further capital to purchasing U.S. Treasuries. So it would seem that bond yields are more likely to remain low; this means that real estate cap rates will likely decline, driving real estate values and returns higher.

Still, there are many who are sceptical about rates remaining low and point to the Bank of Canada ratcheting up the target for the overnight rate as evidence that rates are rising. I've written in the past that REITs are sensitive to the long end of the yield curve, as their mortgages are generally priced at a spread to long-bond yields. The long end of the yield curve is driven by supply and demand, and not the Bank of Canada. The following chart illustrates this phenomenon as the Bank of Canada has raised the short end of the yield curve since the start of the year; however, with the flood of capital into bond and income securities, the long end of the yield curve has actually fallen since the start of the year.



Source: Bank of Canada

Borrowing and refinancing at lower rates

Even more convincingly, Canadian REITs have borrowed at lower rates recently, compared to at the start of the year, as long bond yields have fallen and credit spreads have contracted. RioCan REIT, the largest REIT in Canada, secured \$150 million in mortgage financing in the fourth quarter of 2009 at a weighted average interest rate of 5.6%. In August 2010, RioCan press released that they had refinanced \$123 million of mortgage debt at a weighted average interest rate of 4.5%. All told, borrowing costs have declined significantly for REITs and Canadian interest rates are actually falling.

One of the other pleasant side effects of low bond yields is the impact on debt refinancing. Looking at the 13 REITs in the S&P/TSX Capped REIT Index, there is the potential to drive meaningful cash flow growth from refinancing maturities at lower (face coupon) rates. Recent mortgage transactions indicate that five-year mortgages are available at 4.5% for commercial REITs. The rate is 3.5% for residential REITs, as they are able to secure CMHC-insured mortgage financing. Collectively, these 11 REITs have approximately \$4.7 billion in mortgage debt maturing from 2010 through 2012. The weighted average coupon rate on this debt is approximately 5.41%, compared to the weighted average potential refinance rate of approximately 4.05%. Over the next seven years, these refinancings have the potential to create \$245 million in value for these 11 REITs, just based on refinancing their upcoming mortgage maturities. This is real cash flow that could be flowed through to unitholders in the form of increased distributions.

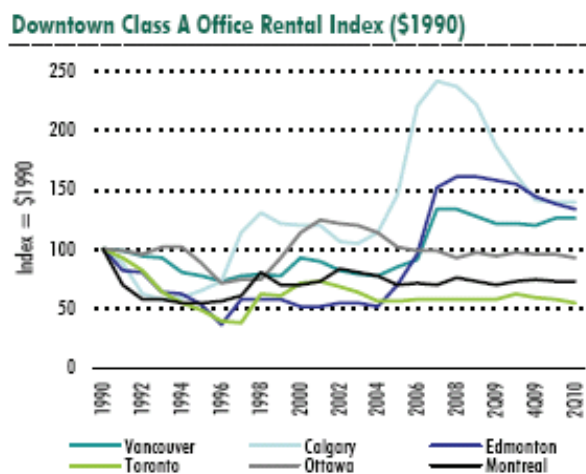
Perhaps the most visible effect of low bond yields on the REIT sector is the ability to structure very accretive acquisitions. Just as corporations are engaging in a global merger and acquisition spree fuelled by cheap debt, so are Canadian REITs aggregating commercial real estate accretively with low-cost mortgage financing. Year to date, Canadian REITs have acquired \$2.5 billion in real estate assets. Given historically low mortgage rates, the accretion on these transactions should drive adjusted funds from operations (AFFO) growth, creating value for unitholders. If AFFO multiples remain constant, REIT values should rise based on AFFO/unit growth fuelled from these acquisitions and interest savings. However, if capital continues to pour into REITs and AFFO multiples expand, REIT unit prices could rise even higher than anticipated.

Standing strong in today's market environment

All of this value creation is possible despite the fact that North American real GDP (gross domestic product) growth should remain muted or below full economic potential for the next few years. On the positive side, in Canada, we have already recovered 100% of the jobs lost during the "Great Recession" and our unemployment rate sits at 8.1%. We have not and likely will not experience a housing collapse of the magnitude of the one currently unfolding in the U.S. And we have not seen a spike in corporate and personal bankruptcies of the same magnitude as that currently experienced in the U.S. Should the Canadian economy show signs of life and real GDP growth re-accelerate, Canadian REITs should see significant cash flow growth from marking rents to market on maturity.

Canadian REITs are currently 96% occupied, which allows many of them to maintain rents upon renewal or re-lease. Should economic activity increase, it stands to reason that companies may begin to expand, thus increasing the demand for commercial real estate. Given the shortage of new supply in the development pipeline and the current high occupancy rates of the Canadian REITs, it stands to reason that rents would rise,

driving AFFO growth for Canadian REITs. Investors should realize that even in an over-supplied market like Calgary, where rents have fallen approximately 40% from their peak, office rent rolls are still positive. Calgary office rents are still approximately 50% higher than they were 10 years ago. Therefore, commercial real estate rents are still likely to rise on renewal, generating AFFO/unit growth for Canadian REITs. A pick-up in the rate of economic growth would likely accelerate this process and create more value for Canadian REITs.



Source: CB Richard Ellis

From 1980 through 1998, North American equities delivered 79% of their total returns in the form of price appreciation, and only 21% in the form of dividends and dividend compounding. From 1998 through today, that equation has shifted to 28% from price appreciation, and 72% from dividends and dividend compounding. By now it is clear that the global economic recovery is slowing. We still have positive economic growth and deflation is not a reality but the level of economic expansion is slowing even in emerging countries such as China. Given the sheer amount of deficit-financed stimulus spending happening in the developed countries, it stands to reason that economic growth will be below full potential and/or muted for the next several years.

Historical asset class returns

INDICES (% Change Y/Y)	2001	2002	2003	2004	2005	2006	2007	2008	2009	Mid-10	Avg.
CANADA											
S&P/TSX Capped REIT Index	29.9%	7.4%	25.9%	14.0%	18.6%	21.2%	-13.1%	-44.6%	37.2%	4.0%	10.1%
S&P/TSX Composite	-12.6%	-12.4%	26.7%	11.3%	22.9%	14.2%	7.0%	-35.0%	30.7%	-3.8%	4.9%
Difference	42.5%	19.8%	-0.8%	2.7%	-4.3%	7.1%	-20.1%	-9.6%	6.5%	7.8%	5.2%
UNITED STATES											
MSCI U.S. REIT Index	12.8%	3.6%	36.7%	31.5%	13.6%	35.9%	-16.8%	-47.8%	21.0%	3.6%	9.4%
S&P 500	-11.9%	-22.1%	28.7%	9.1%	3.0%	11.8%	3.7%	-38.5%	23.5%	-7.6%	0.0%
Difference	24.7%	25.7%	8.0%	22.4%	10.6%	24.1%	-20.5%	-9.3%	-2.5%	11.2%	9.4%
GLOBAL											
EPRA/NAREIT Global Composite	-3.8%	2.8%	40.7%	21.7%	27.5%	23.2%	-18.7%	-47.6%	27.6%	9.7%	8.3%

Source: Bloomberg, MSCI and NAREIT

In that type of economic environment, traditional equities will find it difficult to generate strong earnings growth, and investor returns will continue to be skewed towards dividends and dividend compounding. Investors should gravitate towards those investments that offer strong, recurring and potentially growing distributions. Canadian REITs are an obvious selection and fund flows into the sector should remain robust for that and many other reasons.

REITs deliver more tax-efficient income

It should also be noted that not all yield is created equal. Investors have long preferred dividend income to interest income. The dividend tax credit and lower marginal tax rate means that investors realize greater after-tax proceeds from dividend income than interest income. However, Canadian REITs tend to deliver even greater tax-efficiency through the distribution of “accounting” return of capital (ROC). Canadian REITs generate sufficient free cash flow to pay their distributions, but for GAAP purposes, the majority of these distributions are classified as return of capital. The benefit here is that these distributions are not taxed when an investor receives them. Instead, they reduce the investor’s cost base. When the investor finally does sell the units, he realizes a greater taxable capital gain than he normally would have. Consider that in 2009, 64% of REIT distributions were in the form of ROC.

After-Tax Real Yield Comparison				
	GICs	Bonds	Equities	REITs
Cash Yield	3.40%	5.12%	2.56%	6.12%
Top Marginal Tax Rate	46.41%	46.41%	26.57%	23.83%
After-Tax Yield	1.82%	2.74%	1.88%	4.66%
Inflation Forecast	2.00%	2.00%	2.00%	2.00%
After-Tax Real Yield	-0.18%	0.74%	-0.12%	2.66%
Equivalent Yields	8.70%	8.70%	6.35%	

Sources: GICdirect.com, iShares DEX All Corporate Bond Index Fund, S&P/TSX Preferred Share Index, iShares S&P TSX 60 Index Fund, iShares S&P/TSX Capped REIT Index

Final thoughts

REITs have enjoyed a strong run over the last 18 months and investors might be tempted to pass on a “hot” sector. However, the shift towards income investing is real and enduring, and supports REITs as an asset class of the future. The impending taxation of trusts and historically low interest rates highlights the attractiveness of the tax-efficient, recurring monthly income that REITs provide. Finally, the internal and external cash flow growth opportunities available to Canadian REITs make the sector one of the few poised to show meaningful growth for investors over the next few years. For these reasons, we feel retail investors should heed the words of Jacob Fugger “The Rich” and make REITs a significant portion of their portfolios.

Forward-looking statements:

Certain statements in this document are forward-looking. Forward-looking statements (“FLS”) are statements that are predictive in nature, depend upon or refer to future events or conditions, or that include words such as “may,” “will,” “should,” “could,” “expect,” “anticipate,” “intend,” “plan,” “believe,” or “estimate,” or other similar expressions. Statements that look forward in time or include anything other than historical information are subject to risks and uncertainties, and actual results, actions or events could differ materially from those set forth in the FLS. FLS are not guarantees of future performance and are by their nature based on numerous assumptions. Although the FLS contained herein are based upon what Sentry Investments and the portfolio manager believe to be reasonable assumptions, neither Sentry Investments nor the portfolio manager can assure that actual results will be consistent with these FLS. The reader is cautioned to consider the FLS carefully and not to place undue reliance on FLS. Unless required by applicable law, it is not undertaken, and specifically disclaimed that there is any intention or obligation to update or revise FLS, whether as a result of new information, future events or otherwise.