August 20, 2018

ACCOUNTING ALERT: CANADIAN REITs

An 'Interest'-ing Review of Rate Hikes

REITs Covered	
Allied Properties REIT -(AP.UN)	First Capital Realty - (FCR)
Artis REIT - (AX.UN)	Granite REIT - (GRT.UN)
Boardwalk REIT - (BEI.UN)	H&R REIT - (HR.UN)
Canadian Apartment Properties REIT - (CAR.UN)	Killam Apartment REIT - (KMP.UN)
Chartwell Retirement Residences - (CSH.UN)	Northview Apartments REIT - (NVU.UN)
Cominar REIT - (CUF.UN)	Northwest Healthcare REIT - (NWH.UN)
Crombie REIT -(CRR.UN)	Riocan REIT - (REI.UN)
Dream Global REIT - (DRG.UN)	SmartCentres REIT - (SRU.UN)
Dream Office REIT - (D.UN)	

Real Estate Investment Trusts ('REITs')

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AN INTEREST-ING REVIEW OF RATE HIKES

Despite global economic uncertainty from trade wars and other political pressures, the general consensus is that interest rates will march steadily upwards from their historic lows. Because of high leverage and distributions, Real Estate Investment Trusts ('REITs') and other real estate operators ('REOCs') are one of the most sensitive sectors to rate hikes.

Therefore, as interest rates rise, investors' focus on the sensitivity of profit to interest expense is bound to increase. REITs have long-benefitted from a lower interest rate environment, with lower debt service costs and capitalization rates boosting net asset valuations ('NAV'). However, as rates bottom out, these gains will invariably start to reverse.

In this report, we focus on two components of financial risk within the REIT space: variable rate exposure and near-term refinancing requirements. We also discuss a method REITs use to shield Funds from Operations ('FFO') from interest paid and list the trusts that use this tactic the most.

Of our current recommendations, we see Artis REIT (SELL-rated, C$11.50 per unit intrinsic value estimate) as being the most exposed to a rising interest rate environment. Not only does Artis carry a significant amount of variable debt, it also continues to face headwinds at their Calgary office buildings. This implies that Artis may face difficulties maintaining rents in some geographies, in addition to a substantial debt burden and a high equity distribution commitment.

Other names to monitor include First Capital Realty ('FCR'), Riocan REIT, and Northwest Healthcare REIT, since they carry higher variable rate debt with limited repricing power because of longer-term leases. FCR and Riocan's exposure is partially mitigated by their development potential which, if executed properly, should hedge against rising interest costs.

Highlights from our report:

- **We measure variable debt exposure:** In a rising rate environment, higher variable debt means more sensitivity to immediate interest rate hikes, unless interest rate caps and swaps are purchased. Northwest Healthcare, Dream Office, Artis, Riocan, and SmartCentres have the most variable rate debt at the end of Q2-F18, with variable rate exposure of 18% - 30% of total debt.

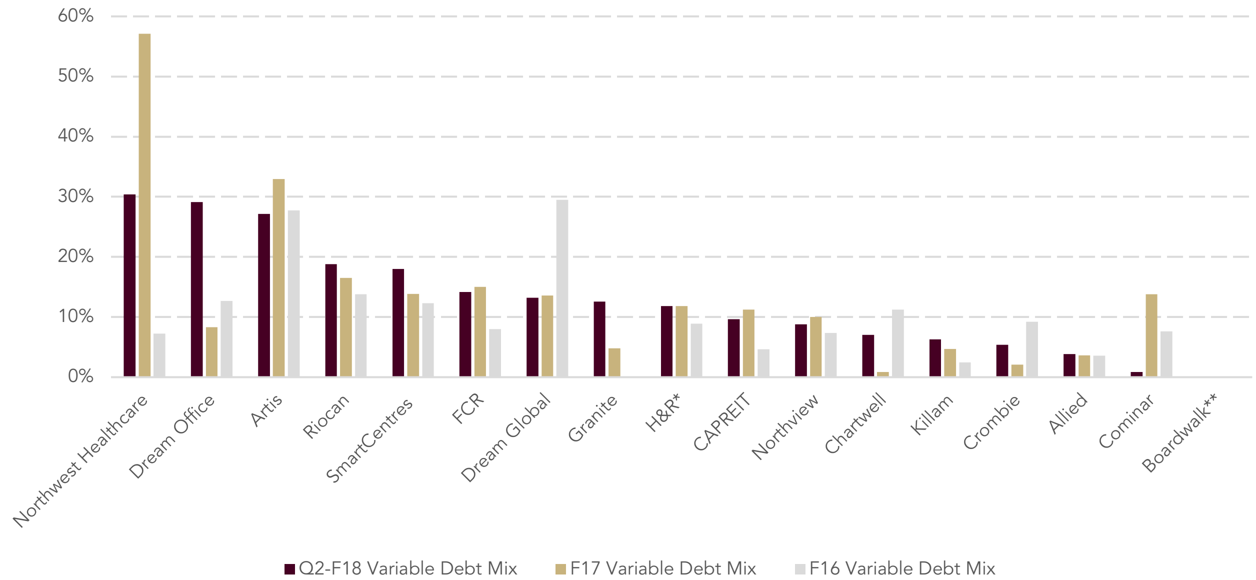
- **We test interest rate sensitivities on debt refinancing:** The REITs we examined carry very different average maturities on debt. Assuming two 25 bps hikes in F18, and one 25 bps hike thereafter per year until F22 – and assuming that those increases are passed through fully to commercial debt – Northwest, Boardwalk, and Cominar have the greatest headwinds on a per-unit basis based on F17 FFO per unit. Meanwhile Granite, Chartwell, and Dream Office have the lowest exposures on a per-unit basis based on the same measure. We also discuss which asset classes are more favourable versus those that are more vulnerable to a rising interest rate environment.

- **We explain the accounting rules for capitalizing interest and discuss the outliers:** IAS 23 allows REITs to capitalize interest when properties are under (re)development, and Allied and FCR are two of the real estate entities which capitalize the most interest. Capitalizing interest has allowed these two entities to increase Q2-F18 YTD FFO per unit by 11.6% and 8.4% respectively.

VARIABLE DEBT VARIES FOR THE REITS

REITs capitalized on low interest rates by obtaining variable-rate mortgages, lines of credit, or issuing senior notes. With rates rising, we would expect REITs to slim down variable debt offerings. However, the total variable debt mix *rose* instead, from 10.2% in F16 to 14.0% in F17 (although it was trimmed slightly in Q2-F18 to 13.1%). That said, there are a few trusts that have slimmed down variable debt. See Figure 1 for a summary of the variable debt mix for 17 of the largest REITs/REOCs in the Canadian sector:

Figure 1
Northwest, Dream Office and Artis lead in Variable Debt Mix in Q2-F18
Sorted from highest to lowest variable debt mix in Q2-F18



Note: We use financial statement figures and net out variable debt with interest rate caps and swaps if they were clearly disclosed as offsetting the related debt. Receivables bearing interest at floating rates are not included in the scope of this analysis.

** H&R does not provide discreet disclosure of variable debt on a quarterly basis . Therefore, we use F17 figures as an approximation for Q2-F18.*

*** Boardwalk does not have any variable rate debt; all of their debt uses fixed-rate mortgages*

Source: Company Reports and Veritas

Based on our analysis, investors in the most exposed REITs (**Artis**, **Dream Office,** and **Northwest Healthcare**) are implicitly betting on:

- Interest rates *staying low*, or at the very least, increasing slowly, and/or;
- The REIT's leases laddering well to match increased interest expense of the underlying properties.

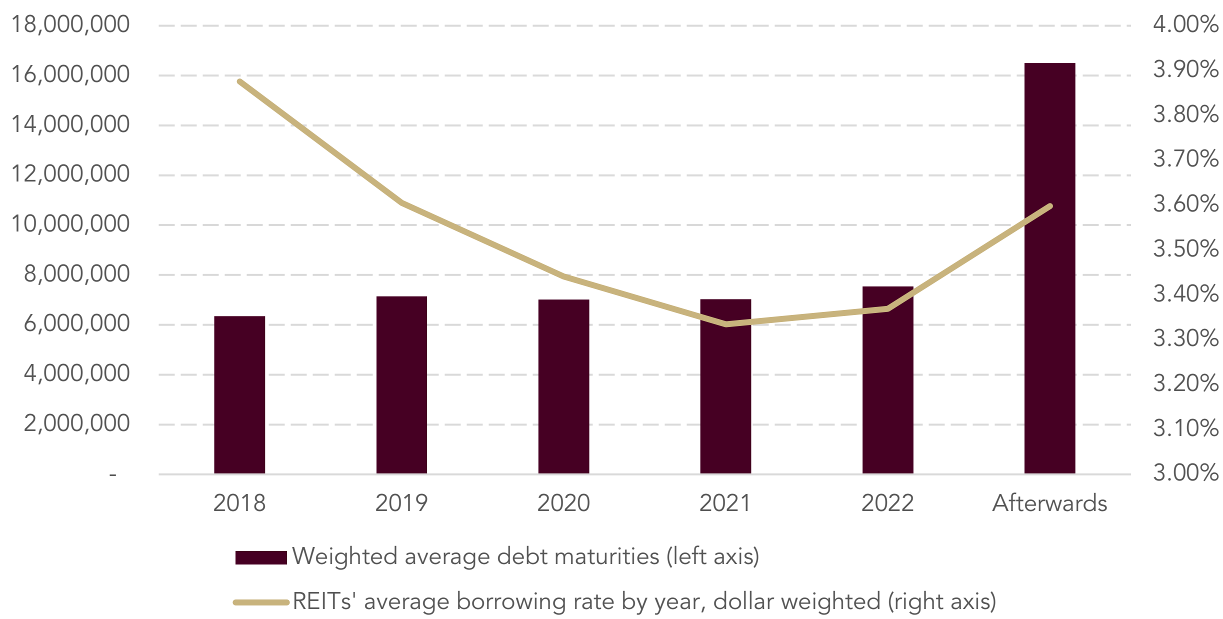
The overall increase of variable debt was primarily driven by increased drawdowns on unsecured credit facilities and construction loans payable to fund development projects. Most REITs are increasing their (re)development activities and sometimes favour variable sources of financing as they are more flexible (i.e. fixed rates can be locked in later) and bear lower *short-term* interest costs. We warn, however, that investors may bear the cost if rates were to rise sharply.

Interest Rates Sensitivity

In addition to variable rate debt, the other component of debt that affects financing costs in an upward rate hike cycle is the debt ladder. If debt matures sooner, interest expense will likely increase if maturing debt is refinanced on similar terms (i.e. principal and maturity).

The most liquid large cap REITs on the TSX carry over $51 billion of mortgage and other debt. However, we note that no more than 15% of that debt load expires in any given year, limiting interest rate risk. That said, if interest rates continue their upward trajectory, REITs could still face a steep rate hike when those lower-rate debt instruments are refinanced. See Figure 2 below:

Figure 2
Future Debt Maturities Tend to Expire at Lower Interest Rates
Debt maturities in thousands of Canadian dollars



Note: This analysis is conducted as of F17

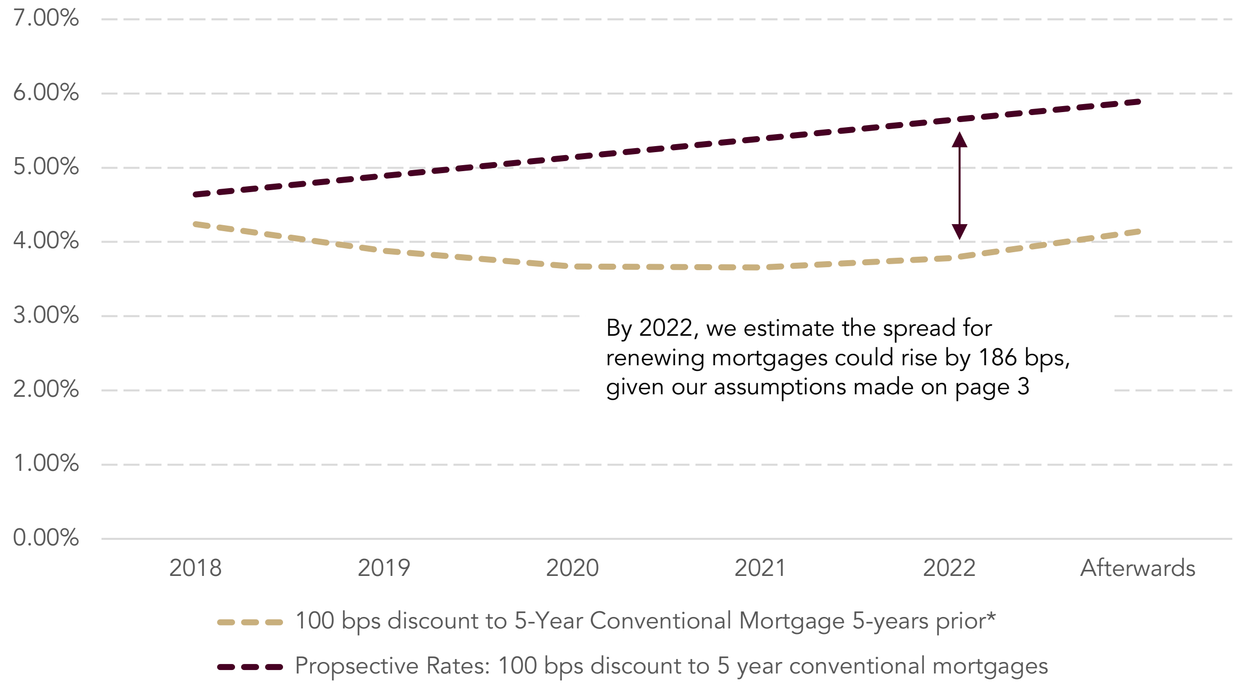
Source: Company Reports and Veritas

Next we estimate the additional interest costs REITs may incur under the following assumptions:

- REITs get a 100 bps discount on 5-year conventional mortgage rates posted by the banks;
- The discount to the mortgage rate does not change, and;
- The mortgage rates are hiked by 25 bps a year starting 2019.

With these assumptions, we can compare the prospective conventional mortgage rate with conventional rates in the past. Based on our analysis, it appears that by 2022, REITs will have to pay, on average, 186 bps more to renew their five-year mortgages. See Figure 3 on the next page:

Figure 3
REITs Exposed to Higher Interest Costs Upon Refinancing



Source: Company Reports and Veritas

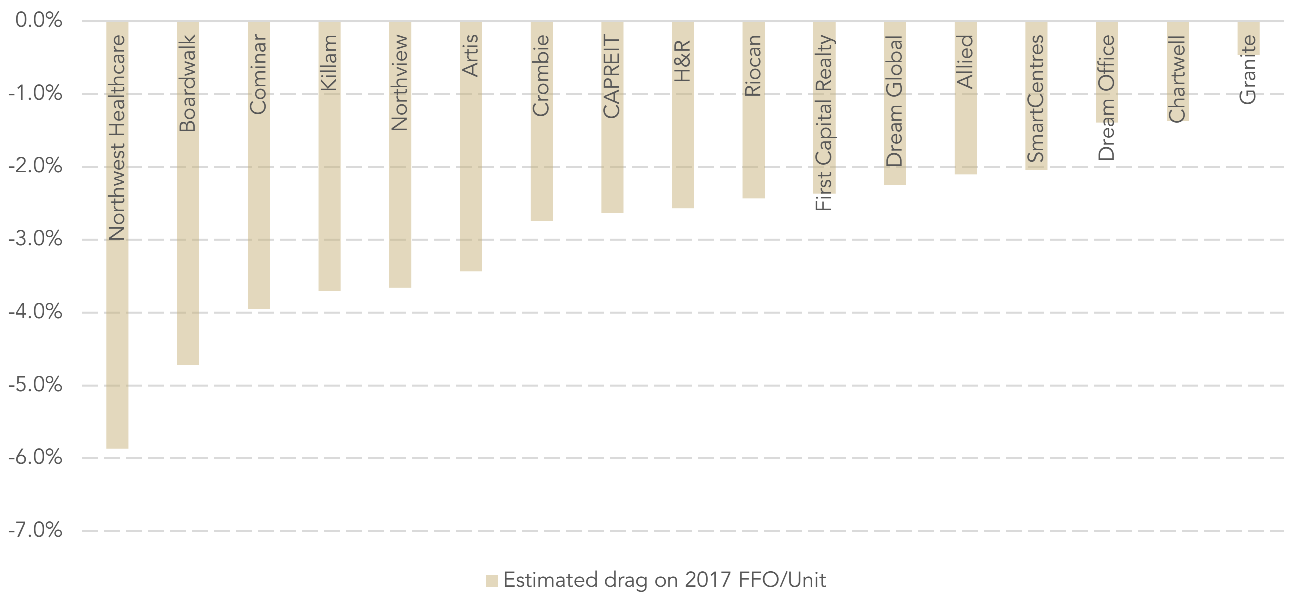
Even if rising interest rates aren't immediately detrimental to REIT profits, valuation multiples could decline as investors are attracted to more appealing alternatives in the bond market

In Figure 4 (next page), we summarize the sensitivity of each REIT's FFO to rising interest expense assuming the same pace of rate hikes as above (i.e. there are 50 bps of rate hikes in 2018, and then 25 bps more per year until the end of 2022), at which point Canada's overnight rate would be at 3.56%, which is near pre-recession levels (i.e. Spring 2008). We also assume that these hikes will proportionately push up funding costs for the REITs as loans are refinanced, which is not always the case as expiring rates may still be higher than market rates, as described above.

Per our analysis, **Northwest Healthcare REIT, Boardwalk REIT, and Cominar REIT** appear to be the most affected. However, we note that **Boardwalk** and **Cominar** also have very short-term leases, which can offset rising interest expense if they are able to reprice their rental rates high enough. Furthermore, the FFO/unit impact is measured, with the highest exposure at Northwest only amounting to 5.9% of its 2017 FFO per unit.

Figure 3

Drag on 2017 FFO/Unit if interest rates were hiked 50 bps in 2018, then 25 bps per year until 2022



Note: This analysis is conducted as of the end of F17

Source: Company Reports and Veritas

Although rates are rising, two factors mitigate associated financial risk for REITs:

1) Despite three cumulative hikes since 2017, some REITs continue to refinance mortgage debt at lower rates. This is largely because the last rate cuts were done in 2015 and many REIT refinancings are on mortgages that were negotiated before 2015.

2) The asset class each REIT operates also affects sensitivity to interest rate hikes:

   a. **Multi-res has repricing power:** Although there are rental hike caps in key geographic markets (i.e. Ontario), multi-residential REITs can raise their market rate for tenants when they move out. Even CAPREIT, which has geographic concentration in rent-protected Ontario, experienced suite turnover of 9.7% in the first half of Q2-F18. Therefore, we expect multi-res REITs to be able to offset – at least in part – higher interest costs by hiking up market rents for new tenants. Therefore, while Boardwalk and Killam's refinancing bears some risk, it is offset by the ability to reprice rents.

   b. **Office/Industrial has medium-term stakes:** Both asset classes typically have medium-term leases (three to five-year average remaining lease terms). Some REITs include contractual step-ups in their leases, while others don't. Compared to retail, we don't believe it is the worst asset class in terms of interest rate exposure, although REITs with more favourable properties in an inflationary environment (i.e. Allied) should fare better.

   c. **Retail has longer lease terms**: With the longest average lease terms and little variable rents, retail REITs have very little pricing power. In our view, retail REITs could fare the poorest in a rapidly rising interest rate environment, especially given the headwinds in retail from e-commerce.

IAS 23: Capitalizing on Some Interest Relief

IAS 23 allows REITs and REOCs to capitalize interest on buildings that are under construction or redevelopment, as long as that building takes a "substantial period of time to get ready for its intended use". As expected, the interest expenses on debt specifically tied to development are capitalized. However, **REITs can also capitalize a portion of general debt (which includes debentures and senior notes) to their development projects.**

Once a building is substantially complete, capitalization of interest stops. In our view, one issue is that IFRS is rather vague as to when a building is substantially complete. Per our discussions with **SmartCentres REIT,** they stop capitalizing interest (and start fair valuing the building) when the development is substantially complete. They typically use a threshold of 60%-70% completion for most projects.

We note that the interest capitalized never has to be amortized or *directly* recognized in cash-based performance metrics, such as FFO and AFFO. As such, we believe there is a significant incentive for REITs to put interest expenses in the development bucket as opposed to expensing and reducing reported FFO/AFFO.

How does capitalization of interest work? We illustrate using a theoretical example below.

Assume that:

- A REIT holds two loans:
    - A $2 million secured construction loan solely used to develop a building yielding interest of 2%, and a $3 million general line of credit yielding interest of 3%;
    - The loans fully used since the start of the year; and
    - The interest incurred on the construction loan was $40,000 and the interest on the line of credit was $90,000
- The expenditure incurred in the year to develop this building was $3 million. Assume the expenditure was incurred at the start of the year (otherwise, the expenditure is pro-rated)

To capitalize:

- As the expenditure incurred to develop the building *exceeded* the secured construction loan, *all* the interest incurred on the construction loan (i.e. $40,000) can be capitalized.
- The *residual* pro-rated development expenditure of $1 million can be capitalized by the weighted average borrowing cost of the general borrowings, which in this case is 3%.
- Therefore, the amount of interest capitalized relating to the line of credit is $30,000 ($1 million * 3%)
- **The total interest capitalized would be $70,000 (i.e. $40,000 + $30,000)**
- Effectively, in this scenario, more than half (53.8%) of the interest paid is excluded from FFO and AFFO metrics!

Based on Figure 4 on the next page, **Allied**, **FCR**, **Riocan**, **SmartCentres**, and **Killam** appear to capitalize the most interest for project construction/development. However, they also have some of the most significant development projects.

Figure 4

REITs have Increased their Capitalization from 5.4% to 6.8% of Total Interest Expense

Interest expense in thousands of Canadian dollars

	Q2-F18 YTD			F17			F16		
	Total Interest Expense (incl. Capitalized)	% Capitalized	Effect on FFO/Unit	Total Interest Expense (incl. Capitalized)	% Capitalized	Effect on FFO/Unit	Total Interest Expense (incl. Capitalized)	% Capitalized	Effect on FFO/Unit
Allied	51,062	23.1%	11.6%	89,621	22.7%	10.3%	82,510	25.6%	10.7%
Artis	49,784	1.0%	0.5%	97,071	0.6%	0.3%	108,703	0.5%	0.2%
Boardwalk	39,107	0.6%	0.4%	70,366	0.3%	0.2%	69,853	0.1%	0.1%
CAPREIT	61,650	0.0%	0.0%	111,138	0.0%	0.0%	109,097	0.0%	0.0%
Chartwell	39,101	5.1%	2.2%	74,030	3.9%	1.5%	69,863	1.6%	0.6%
Cominar	83,333	4.6%	3.6%	179,012	5.7%	4.1%	177,452	3.8%	2.3%
Crombie	54,957	3.4%	2.0%	108,165	2.2%	1.3%	100,657	0.5%	0.3%
Dream Global	21,457	0.0%	0.0%	35,201	0.0%	0.0%	40,810	0.0%	0.0%
Dream Office	29,906	0.0%	0.0%	86,560	0.0%	0.0%	128,384	0.0%	0.0%
First Capital Realty	88,558	14.6%	8.4%	179,082	12.1%	7.6%	180,991	12.3%	8.3%
Granite	10,969	0.0%	0.0%	20,011	0.0%	0.0%	19,996	0.5%	0.1%
H&R	138,005	0.7%	0.4%	272,996	1.0%	0.5%	289,434	0.7%	0.4%
Killam	19,517	8.4%	4.3%	35,108	5.6%	2.6%	37,103	2.5%	1.3%
Northview Apartments	33,239	2.1%	1.1%	68,453	0.6%	0.3%	69,352	1.2%	0.6%
Northwest Healthcare	60,692	0.0%	0.0%	102,929	1.1%	1.1%	76,216	0.5%	0.4%
Riocan	101,661	18.1%	6.3%	199,817	14.2%	4.9%	206,989	13.3%	5.0%
Smart Centres	81,765	13.5%	6.1%	154,373	13.0%	5.8%	167,942	12.0%	6.0%
Weighted average	**964,763**	**6.8%**	**3.3%**	**1,883,933**	**6.0%**	**2.9%**	**1,935,352**	**5.4%**	**2.6%**

Source: Company Reports and Veritas

Keep in mind that our analysis only focuses on the impact of capitalizing interest which lowers interest expense and raises FFO/unit. In reality, developing a property requires other expenditures that are also capitalized, such as construction costs, that would have otherwise also lowered FFO/unit.

Maintaining Interest on Future Rates

Of our current recommendations, we see **Artis** REIT (SELL-rated, C$11.50 per unit intrinsic) as being the most exposed to a rising interest rate environment. Not only does Artis carry a significant amount of variable debt, it also faces headwinds in their Calgary office buildings. This implies that Artis may be challented to even maintain rents in some geographies, despite a substantial debt burden and high equity distribution.

Other names to monitor include **FCR**, **Riocan REIT**, and **Northwest Healthcare REIT,** due to higher variable rate debt and/or debt maturities, combined with limited repricing power because of longer-term leases. FCR and Riocan's exposure is partially mitigated by their development potential which, if executed properly, should hedge against rising interest costs.

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