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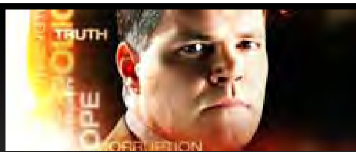

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REITS may appeal to income hungry investors

Paul Sullivan

It's hard to resist the charm of an investment that provides you with income while you watch its market value grow.

Traditionally, investors favoured high-yielding, dividend-paying stocks such as Canadian banks to produce reliable income, but as their prices now reflect their popularity, thrifty investors looking for an alternative might want to consider REITs – real estate investment trusts.

REITs are public companies that trade on stock exchanges like other equities. They hold properties and pay their unit holders cash earned from property incomes and capital appreciation. Historically, REITs land between equities and bonds in both risk and rewards – not as risky as equities, nor as rewarding.

There are relatively few Canadian REITs – 25, according to the Canaccord Adams REIT Review. There are many more U.S. REITs, but it is a good idea to let the U.S. real estate market find its feet before looking south. And the Canadian REITs are performing well – for the week ending Feb. 18, 18 Canadian REITs posted positive results and REITs are outperforming the broader market on a year-to-date basis, 0.7 per cent, compared with 0.2 per cent for the broader market, according to Canaccord Adams' The REIT Review.

Before looking at specific REITs, it is important to note that REITs are not exactly income trusts, and will be exempt from Ottawa's plan to tax trusts that comes into effect on Jan. 1, 2011, but only if they comply with the following rules in a given taxation year: They must hold only real estate properties located in Canada; Their fair market value must be not less than 75 per cent of their equity value; Not less than 95 per cent of their income must be from properties, for example: dividends, interest, rents and taxable gains from the sale of real properties, while 75 per cent of that must come from properties located in Canada. Ottawa will allow this definition of real property to include securities issued by an entity that complies with the above rules, which means a REIT can hold properties either directly or by investing in the shares of a company that meets those rules through an intermediary.

Diane McCurdy of McCurdy Financial Planning Inc. in Vancouver, who specializes in private real estate funds such as the Great-West Life fund, estimates that fewer than half of the current crop of Canadian REITs comply with the rules, and believes another 10 will try to restructure themselves in time to qualify for the REIT exemption, so it is important to determine if a company plans to comply or will be hit with a new tax charge in 2011.

There are two main kinds of REITS, commercial and accommodation focused. Commercial REITS include those with diversified, office and retail portfolios, while accommodation focused trusts include lodging (hotels, motels, resorts), multi-residential apartments and seniors residences.

It is also important to consider a few interesting facts about REITs before going much deeper.

First, REITs don't always trade at fair market value, according to Green Street Advisors Inc., the leading U.S. REIT research firm.

Using a formula based on stock price in relation to net asset value, Green Street determined that in 1990, REITs traded at a 36-per-cent discount to fair value; yet by 1993, they were trading at a 28-per-cent premium. They went down 20 per cent again in the late nineties, but reversed themselves again, and by 2004, were trading at a 22-per-cent premium. This underscores Ms. McCurdy's main concern about REITs: Their liquidity is an asset; their volatility is not.

Secondly, it's looking like 2004 all over again. 2009 was a year of high performance for Canadian REITs. According to PWL Capital Inc., the group posted a total return of 55.3 per cent in 2009, which is still 25 per cent off their all-time highs. While they are still less expensive (and less risky) than most dividend-yielding equities, REITs are not the

bargains they were at the beginning of 2009.

RioCan Real Estate Investment Trust, Canada's largest REIT, has a retail portfolio. It was trading approximately 22 per cent above its net asset value in January and it remained the top-performing REIT for the week ending Feb. 18, according to Canaccord Adams.

The REIT Review reports that the multi-residential sector provides the lowest yield, while lodging provides the highest. On a net asset value basis, the multi-residential sector trades at the greatest discount while the lodging sector trades at the greatest premium.

There are still other considerations. Canaccord Adams reports that REITs are reporting higher occupancy rates than the property market in general, and are showing rising occupancy rates while the rest of the property market still registers declining occupancy.

"The implication is that [REITs] are leading their private peers in terms of fundamental recovery which we believe sets the stage for outperformance at an early stage in the real estate cycle," write the Canaccord analysts who wrote the review.

One REIT worthy of note is included in Raymond James' Canadian Equity Analysts Best Picks for 2010. It's called H&R REIT. Trading at $16.84, H&R is a diversified REIT with a yield of 4.50 per cent, which compares well to RioCan's 4.8 per cent. Perhaps more relevant is the fact it holds The Bow in Calgary, the corporate headquarters of energy giant EnCana Corp.

Most analysts expect REITs, flush with cash (about $1.5-billion raised in the last year according to a Globe and Mail real estate story), will become bigger players in the 2010 real estate market. For example, the Avison Young 2009 Year End Real Estate Investment Review expects REITs to become active in the increasingly hot B.C. market, including secondary markets, such as Kelowna and Nanaimo, as well as Vancouver and Victoria.

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