May 29, 2015

CIBC Wood Gundy

What Clients Should Know About Real Estate Investment Trusts (REITs)

In recent years, we have noticed that some clients who wish to invest a portion of their capital in real estate assets are not aware of publicly-traded real estate investment trusts (REITs). Due to this knowledge gap, they will sometimes consider direct investments in real estate that we would characterize as time consuming, risky and undiversified. To address the knowledge gap, we want to inform all of our clients about the basics of REITs.

A typical publicly-listed Canadian REIT is a diversified portfolio of commercial properties that is contained within a trust structure. Its units can be traded among investors just like the shares of a public corporation. REITs are favorites among income-oriented investors, as they generally pay attractive cash distributions, often on a monthly basis. In addition, REITs have some tax advantages over regular corporations, as they are generally not required to pay Canadian income tax if they distribute all of their taxable income to unitholders.

A good example of a REIT is Canadian Real Estate Investment Trust, or "CREIT" (TSX:REF.un), which has been listed on the Toronto Stock Exchange since September of 1993. According to CREIT, for the 21 year period from January 1, 1994 to December 31, 2014, it has delivered a 15.4% annual compound return to unitholders, assuming that all distributions had been reinvested.[1] The REIT describes its property portfolio and business objectives as follows:

> "CREIT owns and manages a diversified real estate portfolio consisting of retail, industrial and office properties (including a limited number of development properties) throughout Canada and one property in the U.S. The portfolio's 198 properties (including development properties) contain 33.0 million square feet of gross leasable area, with CREIT's ownership interest at 24.9 million square feet. CREIT's primary business objective is to accumulate and aggressively manage a portfolio of high-quality real estate assets and deliver the benefits of such real estate ownership to its Unitholders. CREIT's portfolio is diversified by product type and geographic location."[2]

CREIT has also diversified its tenant base, as no single tenant represents more than 4.6% of gross rental revenues. CREIT's ten largest tenant groups combined represent approximately 19.2% of total revenue.[3] Two examples of Vancouver properties owned by CREIT are 1185 West Georgia Street, a 165,810 square foot office building, and 1508 West Broadway, a mixed-use office and retail complex located at Broadway and Granville and consisting of 82,291 square feet of office space and 64,183 square feet of retail space. We mention these not because they are particularly material to CREIT's portfolio, but simply because many of our local clients like to visualize the type of building owned by a REIT.

On May 29, CREIT units ended the day at $43.11. Its market capitalization (the value of all of its outstanding units) was approximately $3.1 billion. We would classify it as a large REIT by Canadian standards, but it is not the largest. CREIT currently distributes $1.80 per unit per year (paid in monthly increments), for a yield of approximately 4.2%. That is actually a low yield for a REIT. It is not hard to find REITs yielding 6% or more, but CREIT is known for being conservative in its use of leverage and in the amounts it distributes to unitholders.

To summarize the benefits of investing in a REIT like CREIT, we would mention the exposure to a diversified portfolio of high quality commercial properties, a long track record of financial performance, an expert management team, a consistent (and likely growing) distribution, tax advantages, and a relatively conservative financial risk profile relative to many direct investments in real estate. We would also emphasize the ease of ownership, available liquidity, ability to diversify among several REITs without making a large investment and lack of transactional costs as factors worth noting.

Many will wonder whether a high quality REIT like CREIT will outperform a direct investment in real estate, but there are too many variables at play to give a definitive answer. Clearly the leverage inherent in high loan to value direct purchases of real estate can create spectacular gains when the investor buys the right asset. REITs also use leverage to acquire properties, but are usually more conservative than individual investors. (We would not recommend that individuals borrow money to invest in REIT units.)

Especially in recent years, the direct purchasing of real estate by Canadians who are not in the real estate industry has become a financial trend. The expected returns that many Canadians are targeting from these purchases may not be realized, especially if interest rates creep back up towards historical norms. Investors who want real estate exposure in their portfolios should at least inform themselves about the benefits of REITs before making direct property purchases that can be time consuming, risky and undiversified.

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager

Andrey Schmidt *BA, LLB*
Investment Advisor

[1] http://creit.ca/About-CREIT.aspx
[2] CREIT Annual Information Form dated March 26, 2015 (pages 2,3).
[3] CREIT Annual Information Form dated March 26, 2015 (pages 20).