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Kim Inglis, BCom, CIM, PFP, FCSI, AIFP

Generate revenue with real estate

REITs offer steady cash flow

Real Estate Investment Trusts (REITs) are publicly traded trusts that hold, and often manage, revenue-generating real estate assets. REITs are tax efficient and generally pay quarterly distributions. The majority of the cash flow distributed to unit holders is classified as return of capital, reducing the cost base of the unit. Generally the return of capital isn't taxed when the investor receives it, but is taxed as a capital gain when the REIT is sold, and thus tax-deferred.

In the wake of major changes to income trusts, many investors faced significant shortfalls in retirement funding. As income trust distributions were cut and conversions took place, investors looked to REITs' hefty yields as one solution. That popularity grew after the financial crisis, when even more investors turned to income-producing investments. With current interest rates remaining low investment in REITs continue to rise, resulting in double-digit returns for the sector on a year-to-date basis.

Recent strong outperformance of the S&P/TSX Capped REIT Index, relative to the broader equity market, is supported by three factors carried over from 2011 into 2012. There have been strong property market fundamentals throughout all asset classes, characterized by falling vacancies and rising rents. A wide positive spread investing environment has facilitated significant accretive acquisitions, and the interest rate environment has allowed refinancing of maturing debt at historically low rates.

Some question whether REITs can sustain their popularity, given the significant interest in them over the last few years. According to Canaccord Genuity analysts, REITs are here to stay. They believe that real estate is a cyclical asset and that we have reached a point in the cycle where property fundamentals are entering the growth stages. The current interest situation bodes well because attractive borrowing costs in turn drive further investing opportunities.

The analysts point to growth in tenant demand as a key indication. It is outpacing new supply, which should drive vacancies lower and rental rates higher. On a year-over-year basis, the vacancy rate in the Canadian office sector fell to 8.3% in Q3/12, marking the thirteenth consecutive quarter of positive absorption.

And, funds from operations on a per unit basis have continued to grow at a healthy pace. In Q2/12, commercial REITs saw average FFO/unit growth of 10.0% while residential REITs rang in at 4.5%.

Dennis Mitchell, CIO and Senior Portfolio Manager of Sentry Investments, believes this trend will continue and that rising cash flows ultimately support rising distributions and unit prices. He points to contractual rent increases, positive

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leasing spreads, and debt refinancing as key factors driving the growth. He also sees REITs developing on excess land or expanding existing properties and making accretive acquisitions, due to the current low cost of capital.

There are no indications that market volatility is going to abate, or that returns will soon improve significantly in the broader bond and equity markets, so investors are seeking yield as a primary source of investment return. As an asset that offers steady cash flow, REITs help fill the bill.

Kim Inglis, CIM, PFP, FCSI, AIFP is an Investment Advisor & Portfolio Manager. The views in this column are solely those of the author. www.kiminglis.ca

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