NATIONAL POST
FINANCIAL POST

JULY 31, 2010

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Real estate without bricks

An examination of Real Estate Investment Trusts (REITs)

Investors looking for income should consider Real Estate Investment Trusts (REITs) - publicly listed, closed or open-ended trusts that hold income-producing real estate such as shopping malls, apartment buildings, commercial properties and hotels. Investors acquire exposure to real estate, without huge capital outlays, by owning units rather than directly investing in the properties, and they receive distributions from income generated by the properties.

Although property values have declined from peak 2007 levels, a number of positives remain for Canadian REITs. Over the past 12-18 months, many took advantage of capital market improvements to raise debt and equity capital, and it's estimated they raised $1.5 billion with much of it still on the balance sheets. That means those REITs are well positioned to acquire assets at distressed prices.

In a recently updated report, CB Richard Ellis notes that Canadian office and industrial markets are exhibiting stable to improving fundamentals because of positive space absorption and shrinking new supply. The combination of these factors should bring overall vacancy rates lower and drive rental rates upward.

The return of healthy fundamentals in the office and industrial markets bodes well for Canadian commercial real estate stocks from now into 2011. Combined with a likely deployment of excess liquidity into acquisitions that increase earnings, it also bodes well for unit holder payouts.

REITs can benefit from the demise of income trusts in 2011. With many income trusts forced to cut distributions on conversion, income-oriented investors face shortfalls in retirement funding. Many analysts believe they will move a portion of their assets into REITs because of the hefty yields. About $20 billion is invested in income trusts, so even a small percentage shifted to REITs will be a very large inflow of cash.

By diversifying into REITs, you gain a number of immediate advantages. Canadian REITs are currently yielding approximately 4% to 9%. Also, they trade on the exchange and thus offer a much higher degree of liquidity than traditional real estate.

Investors benefit from the potential for capital appreciation. Not only is the increase in asset value reflected in the unit price, but so too are any increases in income growth. Benefits accrue when the underlying property values rise, as well as when rents or leasing terms are increased.

REITs are very tax-efficient. The majority of the cash flow distributed to unit holders is classified as return of capital, which reduces 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 is thus tax-deferred. Since it's taxed as a capital gain, it receives better tax treatment than interest income from a bond.

Canadian REITs were first introduced to the markets in 1993 and have since become a very popular investment vehicle. There are now many different types available, with a wide variety of investment choices, and it is wise to seek expert advice to ensure the right fit for your portfolio.

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