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Reiterating some 2013 REIT investment realities

Since rebounding from the financial crisis, Real Estate Investment Trusts (REITs) have been in investors' crosshairs, with the bulk of the draw being juicy yields. However, investors making investment decisions based solely on yield should be cautious.

According to Canaccord Genuity analysts, several factors can affect a REIT's yield including leverage, asset quality, payout ratio, and growth potential. These factors can significantly affect the sustainability of the yield and, ultimately, after-tax returns.

Leverage opens the door to opportunity for REITs because low interest rates allow acquisition of properties with the potential to add significant future value. However, vulnerability to interest rate movements means that operating with large amounts of leverage carries higher levels of risk. Deciphering the calculated risk associated with leverage is key.

In a REIT's portfolio, asset quality depends on asset class, geography, and asset age. A REIT with lesser quality assets and a higher yield can be enticing, but an investor may be better off opting for a REIT with high quality buildings. Although the income will be lower, it is more predictable and more likely to be sustainable.

Payout ratios are another aspect often overlooked by investors. While 100% payout ratios seem appealing, they are riskier. According to Canaccord Genuity analysts, REITs often set their payout ratios close to, if not above, 100% in order to attract investors and make themselves more attractive relative to other public real estate investments. But a payout ratio greater than 100% means the REIT must use cash resources or borrow in order to maintain the distribution - obviously not a sustainable strategy for the long-term investor.

Investors must assess the growth potential of the REIT carefully. There will be instances when a REIT has a low yield, yet good prospects for higher cash flows in the future. For instance, although the low yield may be due to assets having high vacancy rates, the assets may be located in a region with a growing economy and have the potential to fill those vacancies.

When assessing yield, investors should also determine the after-tax return. As trusts, REITs pay distributions and the overall taxation of those distributions depends on its components. While REITs are generally considered to be tax efficient vehicles, some components are more favorable than others.

The majority of the cash flow distributed from REITs 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

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sold, and is thus tax-deferred. Some cash flow can be considered capital gains if a REIT realizes a gain from one of their asset dispositions. REITs may also receive dividend income and flow it through to unitholders as an eligible dividend, thereby qualifying for the dividend tax credit. In some instances a portion of the distribution is considered interest and is taxed at the unitholders' marginal income tax rate.

Given the current low interest rate environment and investors' continued demand for yield, it is likely that REITs will remain popular. Investors should be discerning and do their homework in order to choose the highest quality REITs, and avoid making choices based only on yield.

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