Celebrating 25 Years of Canadian REITs

REALPAC RealREIT

A Quarter Century of Rising Distributions:

Michael Brooks
Chief Executive Officer, REALPAC

In 2018, the Canadian real estate investment trust (REIT) industry turns 25. It's been an incredibly successful investment, now offering opportunities in the 4 major asset classes, and with a collective market cap of over $72 Billion.

The REIT vehicle itself is purpose built for the investor who wants exposure to large office, industrial, multi-family and retail assets, liquidity, professional management, stability, an attractive yield, and growth, packaged in a tax efficient vehicle.

Canada was the third advanced economy to allow the REIT, following the U.S. (1960) and Australia (1971), although many smaller economies created similar vehicles before the year 2000 (Taiwan, Belgium, Brazil, Netherlands, and Turkey). Now there are over 35 countries with REIT legislation of one sort or another.

But let's go back to the beginning. Why were REITs created in Canada? The answer may surprise you.

1980 - 1990

To understand the emergence of Canadian REITs, you have to understand the real estate markets in the 1980s and the early 1990s. The 1980s saw the rise of public development companies, and a development frenzy nationwide in many Canadian cities. In the six years between 1984 and 1990, Toronto had developed approximately as much office space as the previous 84 years. This period saw the construction of many Toronto office landmarks, such as Brookfield Place, Scotia Plaza, the Toronto Dominion Centre 4 and 5 towers, the National Bank Building, the Sun Life East and West buildings, Citibank Place, and the Exchange Tower to name a few. However, the slowdown that gripped most of Canada starting in 1989 exposed many flaws in the system of development. Leverage levels were too high. Too much development was speculative. Fiscal discipline was lacking.

While the recession itself might have only technically lasted four quarters (1990/1991), the real estate market in most Canadian cities struggled to find any growth until about 1995. American developer Sam Zell was credited with coining the line – "stay alive until 1995". As the slowdown deepened, office vacancy rates in Toronto rose, reaching well into double digits. Net effective rents in Toronto office buildings plummeted, with some lease deals being done at a net effective rent of negative $5 dollars per square foot. At that rate, the landlord is merely getting a property tax and operating cost subsidy from the tenant, and making nothing on its equity.

1990 - 1995

For most of 1990 to 1995, there was literally no one on the buy side for major commercial properties in the City of Toronto. Lawyers became very well practised in mortgage remedies such as foreclosure, operating a building reluctantly and considering when and if they'd ever be able to recoup their losses.

The result was the utter collapse of the real estate industry. Just about every large or public commercial property company was either bankrupt or technically insolvent. That included large public companies Bramalea Properties, Markborough Properties, Trizec, Olympia and York, BCE Developments and many more. Some of those companies came out of bankruptcy or insolvency reborn, including Cadillac Fairview and Oxford Properties. The recession collateral damage also included the destruction of almost an entire banking sector: the trust companies, who were the main lenders to the real estate developers. It was also the end of many industry service providers such as construction, architectural, and engineering firms, who saw a precipitous decline in business, coupled with uncollectible accounts receivable.

The 1990 – 1995 period in Canada and the devastation of the commercial real estate industry signalled the end of many practices including lax banking standards to the real estate sector, most speculative development, the "no money down" deal-making, and (for a little while) non-recourse loans. It also marked the beginning of the professionalization of Canadian commercial real estate, the recapitalization of public real estate companies, and the entry into the industry of institutional capital, such as pension funds.

The Genesis of the Canadian REIT

Real estate mutual funds, private real estate syndications and real estate limited partnerships in existence in 1989 were also in a predicament. As property values started to decline in 1990, fund unitholders, investors and partners asked to redeem their units or interests. However, without anyone to sell to, fund managers, general partners and promoters were unable to generate the liquidity to pay redeeming unitholders and partners. Real estate managers were forced to suspend redemptions, and think about other ways to provide liquidity. After it became clear that the market depression wasn't going to be a short one, those managers had to think of alternative approaches.

A particular nuance in the Income Tax Act relative to real estate mutual funds required them to be, in effect, privately held. After some creative thinking and numerous lobbying pilgrimages and submissions to the Department of Finance in Ottawa by REALPAC, lawyers for two real estate mutual funds (the first recently known as Canadian REIT or CREIT, which was acquired by Choice Properties REIT in 2018, and the second now known as RioCan REIT), together with other industry participants, the group was able to secure an amendment to the Income Tax Act, to allow the listing of real estate mutual funds on the Toronto Stock Exchange.

So the Canadian REIT vehicle was born out of necessity, and out of a small tweak to the Canadian Income Tax Act, providing an exit strategy for real estate mutual fund holders from the ravages of the 1990-1995 real estate doldrums. There was no specific legislative framework, and the Canadian REIT vehicle has continued as a business trust ever since. This is to be contrasted with U.S. REITs, a creation of the U.S. federal government, as a flow-through corporate vehicle or trust for conscious policy reasons.

1997 - 2006

There have been many other milestones along the way dealing with improvements to the REIT vehicle and the legal elements of a publicly traded trust. The movement to internalization of management started in earnest in 1997. In 2000, the first convertible debentures were issued. In 2001 we had our first cross-border REIT. By 2004, we had specific REIT legislation in Ontario limiting unitholder liability like in a corporation (the Trust Beneficiaries Liability Act), written by REALPAC, and followed in most other provinces in Canada. By 2005, REALPAC and others had convinced Standard & Poor's to allow REITs to be considered for the TSX Composite Index.

On October 31st 2006, in the so-called "Halloween massacre", Finance Minister Jim Flaherty eliminated almost all other income trust vehicles through elaborate tax rules (the eliminated income trusts were called Specified Investment Flow Through vehicles or SIFTs). REITs generally, as passive investment vehicles, were spared, although the same elaborate tax rules eliminated REIT status for hotels and seniors housing, as they were considered to be carrying on active business in real estate.

Present Day

Fast forward to 2018, and our Canadian REIT universe continues to expand its reach.

High original yields on Canadian REITs and high payout ratios have slowly moderated to more sustainable levels. Today, some REITs still offer high yields, but many also have cash distribution yields that are in-line, or even lower than, some of the more traditional equity-income sectors such as banks, telecom companies, pipelines and utilities. This is because a good number of REITs today have very high quality portfolios, significant operating platforms, conservative financial leverage and cash distribution profiles, and significant opportunity (and capability) to create value through property development, redevelopment and intensifications. As such, REITs of this character are not owned by unitholders for their cash yield, but rather for their total (i.e. income plus capital appreciation) return potential.

Canadian REITs have been very good at recycling capital. Most have a very good disposition and acquisition program, allowing them to sell mature assets for those with more upside potential. Recently, REITs like Dream and Cominar have been very active in restructuring their asset bases.

Canadian REITs have been city builders. Many of these REITs were active in mixed used projects before the trend, and some of the more recent projects such as The Well (involving Allied Properties REIT and RioCan REIT) demonstrate the world class development skills that our major Canadian REITs now possess.

Several of our Canadian REITs now provide European exposure–Dream Global REIT, Inovalis REIT, and Granite REIT for example. Others provide some global exposure, such as Northwest Healthcare Properties REIT. Many provide U.S. exposure in whole or in part, such as WPT Industrial REIT, H&R REIT, and Pure Multi-Family REIT LP. And in Canada, investors have the choice of single purpose REITs in office, retail, industrial, and multi-family asset classes.

The value of Canadian REITs has recently been validated by significant merger and acquisition activity. Blackstone and Ivanhoé Cambridge took over PIRET this past spring. OneREIT was split into two pieces, with components of the portfolio purchased by a fund managed by Strathallen Capital and SmartCentres REIT. Choice Properties REIT acquired CREIT and Brookfield Property Partners bought out all of Brookfield Office Properties Canada last year.

The Next 25 Years

While many Canadian REITs are being run by their original (and very experienced) management teams, we are already starting to see a transition as younger next in commands either step up, or are hired from outside to carry the REIT forward for the next 25 years. Most REITs now have significant development activity, so don't need to rely solely on rental increases or cost reductions to grow unit values. As the Canadian REIT Industry continues to expand, REALPAC will continue to work with regulators at all levels, nationally and internationally, to grow the vehicle and provide Canadian investors the access to professionally managed big-ticket real estate, providing dividends and diversification, in an efficient structure. We're proud to represent the majority of REITs in Canada, and help strengthen the economy through growing employment, facilitating investment in and development of real estate, protecting the environment and growing strong urban centres nationwide.

REALPAC RealREIT

Q1: How has your REIT's strategy evolved since its inception?

When Northern Property REIT (predecessor to Northview Apartment REIT) was formed in 2002, the strategy was focused on investments in high yield apartments in the Northwest Territories and Nunavut, supplemented by investments in resource based markets in western Canada. Since then, the strategy has evolved into more mainstream markets across Canada, particularly since the acquisition of True North Apartment REIT in 2015.

Todd Cook, President & CEO,
Northview Apartment REIT

Since our IPO in 2013, we have always focused on highly-functional, well-located U.S. industrial properties. More recently, we have also made a strategic push into new markets and increased our development and value-add investment activity. What hasn't changed at all, however, is our core focus on long-term value creation.

Scott Frederiksen, Chief Executive Officer,
WPT Industrial REIT

CAPREIT's original strategy revolved around the notion of buying apartment buildings at a significant discount to replacement cost. Mike Stein and Tom Schwartz saw the stable opportunity that residential rental income offered. Tom was a visionary ahead of his time. In short, CAPREIT provided a unique new service that the rent-controlled industry simply didn't understand.

Today those original ideas remain the corner stone of our strategy, however, we have evolved to embrace adding value through capital, investment, and quality from a service point of view. CAPREIT sees tremendous opportunity in the strength of our operating platform, a platform we have taken across Canada and now Western Europe.

Mark Kenney, Chief Operating Officer, CAPREIT

Artis is a diversified commercial REIT that originally focused on Western Canada and subsequently expanded into new markets in Eastern Canada. In 2010, Artis further diversified by venturing south and acquiring properties in the U.S., which not only enhanced the diversity of Artis' portfolio, but also provided a natural hedge against the volatility in the Canadian marketplace. As a result of the strong Canadian dollar at the time, there were compelling opportunities in the U.S. to acquire new, high-quality real estate assets at yields significantly better than those available for comparable product anywhere in Canada and, given the strength of the lending market, at spreads difficult to find in Canadian markets.

Today, we are focused on improving Artis' portfolio and growth profile through accretive recycling of real estate capital and investing in new development projects and newer generation real estate.

To summarize, Artis' core objective is to provide a stable, reliable and tax-efficient monthly cash distribution, as well as long-term appreciation in the value of Artis' units through the accumulation and effective management of quality commercial real estate. It's important to be committed to key strategies to achieve this objective; however, being proactive by anticipating changes in market conditions and allowing the strategy to evolve over time is key to Artis' long-term success.

Armin Martens, President & CEO, Artis REIT

The goal of our REITs is to continually improve the returns from the assets currently owned, and make quality acquisitions that are accretive in the long term. Our strategy to meet those goals has evolved as market conditions change and new opportunities become available.

With the bricks and mortar retail industry undergoing significant change, the strategy for the retail portion of our Canadian REIT – which consists of a diverse mix of Canadian office, industrial and retail properties – is primarily focused on enclosed shopping centres that are dominant in their markets. Through strategic development and a focus on experiential retail, these centers have become destinations that are central to their communities, ensuring robust traffic and activity. Our office portfolio is focused on well-located, high-quality properties in major urban cities and includes a mix of single-tenant and multi-tenant properties.

Our North American Residential REIT aims to expand its asset base in Canada and the United States through acquisitions in major urban and suburban markets and improve its existing properties, enabling us to attract and retain residents. We are also focused on community-building – encouraging long-term occupancies by fostering a sense of home.

Morguard has always been committed to ongoing development and upgrades of its real estate assets – proven ways to increase the value of our portfolio. Transit-oriented development and mixed-use development are key pillars of our growth strategy as we seek to grow our operating cash flow and enhance returns.

K. Rai Sahi, Chairman & CEO, Morguard

At commencement we were simply an acquirer and aggregator of retail real estate assets. But after almost a decade, we started evolving into an active manager of those same assets and added the capability to expand and change them. Then we began building the capability of creating those assets through development while narrowing our focus for new assets on the 6 major markets in Canada. In the last few years, we have started totally disposing of non-major market assets while focusing on redeveloping our existing retail assets into major mixed use assets with a focus on adding a significant residential component.

Edward Sonshine, Chief Executive Officer,
RioCan REIT

Minto Apartment REIT completed its IPO on July 3rd, 2018 with a high-quality apartment portfolio, geographically diversified across major urban centres in Canada including Toronto, Ottawa, Calgary and Edmonton. The REIT's strategy is to grow earnings and net asset value through both organic and external growth.

We will continue to grow organically through our focus on operations and the execution of our asset management plans. Targeted improvements to suites, amenities and building systems improve our product offering and building efficiency. As suites turn and we move our leases from older in-place rents to current market rents we are seeing strong revenue growth.

We will pursue external growth through acquisitions and development opportunities. The management team has demonstrated its ability to source new acquisitions having completed over $900 million in multi-residential rental acquisitions since 2010 and is actively pursuing new properties for the REIT.

The REIT's strategic alliance with the Minto Group, one of Canada's largest residential developers, provides it with excellent growth opportunities through both intensification of existing sites and the development of new projects. The REIT will pursue new development in amenity-rich urban environments with excellent walk scores and access to transit. These locations provide the best opportunity for long term earnings growth and NAV creation.

Michael Waters, Chief Executive Officer, Minto Apartment REIT

Q2: What is key to your REIT's capability to deliver growth and strong performance over the next few years?

Acquiring, developing and investing in high quality real estate in Canada's strong and growing markets; access to capital through both equity and debt markets; and investing in our people to continuously improve our ability to deliver exceptional customer service.

Todd Cook, President & CEO, Northview Apartment REIT

Historically, our growth has come from: 1) contractual rent escalations, 2) rolling below market rents to market rates as leases renew or turnover, 3) property expansions and 4) accretive acquisitions. And we expect to continue these growth strategies over the next few years. We also recently acquired a private capital platform and announced a new value-add and development venture with targeted equity deployment of $1B. We expect our private capital platform and new venture to accelerate future growth and diversification of both our revenues and property portfolio.

Scott Frederiksen, Chief Executive Officer, WPT Industrial REIT

As a leader in the multi-family market, we have tremendous visibility on existing apartment's deals in the market across Canada and now in Europe. We see the ability to develop on our own lands as an emerging driver of growth in the years to come, added refinement to our operating platform is an advantage we have over others who are trying to add value in our sector. The fundamentals of the multi-family market remain extremely positive across Canada and Europe.

Mark Kenney, Chief Operating Officer, CAPREIT

Key to Artis' ability to deliver growth and strong performance is a well-defined strategy, a strong management team and a disciplined approach to implementing our strategy. Organic growth through strong leasing and renewal rent increases producing positive same property NOI growth, and delivering new, leased development projects at comparatively high yields will be key elements to our success.

Armin Martens, President & CEO, Artis REIT

The expertise and capabilities of all our various teams. Management, leasing, development and finance so we can continue to do things better and faster. An economy that keeps ticking along at a decent growth rate, 2% is fine, is also essential.

Edward Sonshine, Chief Executive Officer, RioCan REIT

Minto Apartment REIT is executing its growth strategy against an economic backdrop that is generally very favourable for residential rentals. Demographic changes arising from an aging population and immigration are fueling population growth, particularly in major urban centres. This, combined with challenging home ownership affordability in major markets, is bolstering demand for rental housing and the REIT is well positioned to take advantage.

In addition to continued favourable underlying market conditions, to succeed the REIT will need to continue to source acquisitions with value add or the intensification of potential development opportunities.

Michael Waters, Chief Executive Officer, Minto Apartment REIT

Q3: What are two of the most important things that need to happen to ensure the continuing success of the Canadian REIT market?

1. Capital and debt markets need to remain accessible and affordable to allow REITs to continue to grow and invest in existing properties.
2. Government regulation and taxation must provide opportunities for REITs to expand and invest in the communities we operate in.

Todd Cook, President & CEO, Northview Apartment REIT

Issuers need to focus on improving corporate governance and creating shareholder value over the long term.

Scott Frederiksen, Chief Executive Officer, WPT Industrial REIT

To ensure the continued success of the REIT market, I feel ongoing support of real estate-effecting government regulations and a regulatory environment that sees the economic merit of real estate being held in a REIT structure are two factors for continued success.

Mark Kenney, Chief Operating Officer, CAPREIT

In order to ensure the continuing success of the Canadian REIT market, interest rates need to be stable and predictable. The availability and cost of debt remains the number one risk factor for REITs to manage. In addition, improvements to securities regulations that would align Canada with the U.S. are long overdue and necessary to enable boards and management teams to plan long term and create maximum value for the investing community. Lastly, Canadian REITs will need to evolve to be more in line with U.S. REITs in terms of balance sheet and pay-out metrics, as well as NAV growth profile.

Armin Martens, President & CEO, Artis REIT

Reasonable interest rate climate and a continuing decent economy in Canada are two of the most important things.

Edward Sonshine, Chief Executive Officer, RioCan REIT

Markets have enjoyed decades of stimulative monetary policy and low interest rates. While economists aren't forecasting major increase in the near term, both the Bank of Canada and the U.S. Federal Reserve have begun raising rates. Real rates (nominal rate less inflation) on longer term bonds are near zero today. We can expect rising rate pressures resulting from strong economic growth and employment. How the markets react will be critical to the continuing success of the REIT market.

Secondly, the desirability of real estate as an asset class has attracted a lot of interest from both private investment funds and pension funds. REITs will need to compete for assets in a very competitive marketplace.

Michael Waters, Chief Executive Officer, Minto Apartment REIT

REIT Members of REALPAC

Q4: Unlike the last 25 years in real estate, the next 25 years could potentially have significant headwinds. What do you foresee as the future for securitized real estate in Canada?

The future for real estate in Canada remains strong, especially in the multi-family sector where increase in demand is expected to outpace increases in supply and home ownership will continue to become less and less affordable.

Todd Cook, President & CEO, Northview Apartment REIT

Despite short term noise around issues like interest rate fluctuations or market cycles, the future of Canadian REITs is bright. If REITs remain a transparent investment vehicle that allow all types of investors to own best-in-class real estate with daily liquidity alternatives, we will continue to offer a compelling investment alternative and attract new investors to the sector.

Scott Frederiksen, Chief Executive Officer, WPT Industrial REIT

I think the future of securitized real estate in Canada remains strong, CAPREIT has proven itself to be a world leader in securitizing real estate and exporting knowledge outside the boundaries of this country. The International market for multi-family has never been more promising and provides a tremendous asset class for REITs to prosper.

Mark Kenney, Chief Operating Officer, CAPREIT

During the past 25 years, interest rates trended to ultra-low levels. Today, the outlook is for rates to be range-bound level or rising. This is a disconcerting headwind for the real estate sector to overcome; however, due to the thirst for yield and protection against inflation, demographics will continue to drive investor demand for real estate and REIT securities. This is a long-term structural trend. REITs with solid management teams and good strategies will not only survive, but flourish.

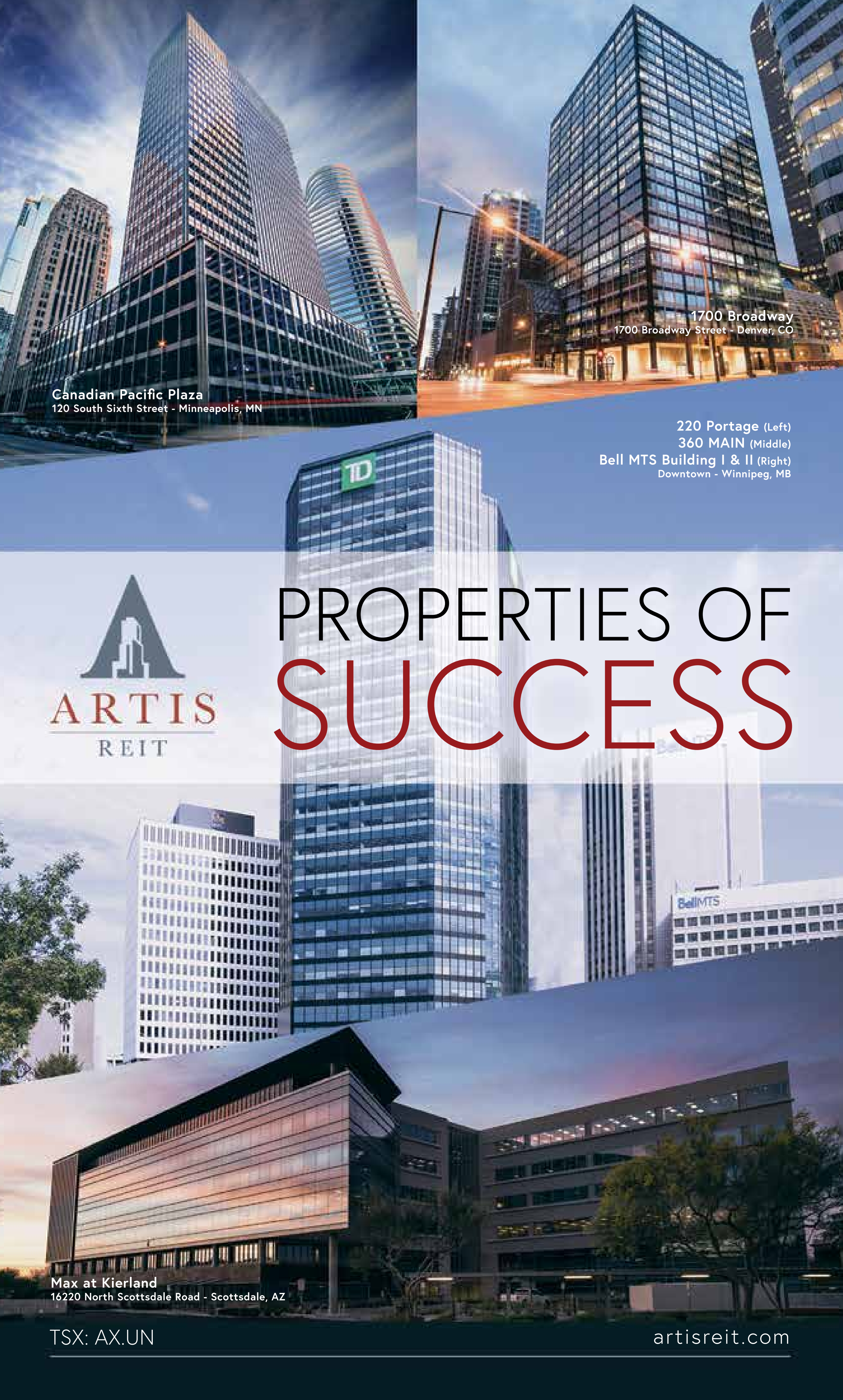
Armin Martens, President & CEO, Artis REIT

Excellent so long as the large REITs continue to perform as they should. I think further growth and consolidation is ultimately going to be required in the face of the much more difficult environment. Simply acquiring assets is no longer the path to success or delivering the growth that public markets require.

Edward Sonshine, Chief Executive Officer, RioCan REIT

The REIT sector in Canada has grown steadily since its inception as they have proven to be a reliable source of both income and capital growth and also provide a source of diversification beyond typical stocks and bonds in investor portfolios. Investors' views on the sector have evolved to emphasize growth in earnings and NAV in addition to yield. Issuers will need to find ways to deliver on those expectations.

Michael Waters, Chief Executive Officer, Minto Apartment REIT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