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Shopping for a REIT? Here's a key factor investors may be overlooking

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Real estate investment trusts come in all sorts of flavours, from apartments to offices, medical buildings to senior living, and, of course, retail.

Those differences are plain. It’s a little bit harder, however, to distinguish which REITs make payments to investors that are most advantageous, tax-wise, and which might have payouts that are a bit more aggressive than they might seem. Analyst ***Howard Leung*** at ***Veritas Investment Research*** recently made an attempt, however, and his findings are of interest to income-oriented investors in the space.

Mr. Leung’s first observation is on what he calls the “tax efficiency” of the Canadian REITs. These trusts are tax-exempt as long as they distribute their taxable income to shareholders. In doing so, they pass that tax obligation to the unitholders, who pay based on whether it’s business income, capital gains and what’s called a return of capital.

Mr. Leung says – and most would agree – that a return of capital is preferable from a tax basis, because unitholders pay no tax in the year it’s received. Instead, the unitholder’s cost base is reduced by the amount of the payment, and is only taxable as a capital gain when the units are sold. Long-time unitholders can defer taxes for the long term via this method.

How does a REIT create a return of capital? Here’s the primary way: Canada Revenue Agency allows REITs to use something called a capital cost allowance as a deduction against its taxable income. More CCAs means less taxable income, and more return of capital in the REIT’s payout to investors. And the newer the trust, and the newer its properties, the greater value of the CCAs. As a trust and its properties age, CCA deductions decrease.

Mr. Leung says this means Milestone Apartments REIT, which did its initial public offering in 2013, and Chartwell Retirement Residences are two of the most “tax-efficient” REITs it looked at. On the other end of the spectrum, Canadian REIT and Boardwalk REIT are among the least tax-efficient.

James Ha, director of investor relations for Boardwalk, acknowledges his REIT hasn’t had a lot of return of capital in recent years, but says he “wouldn’t really call it tax-inefficient, because it’s pay now, or pay later.” Canadian REIT did not respond to e-mailed requests for comment.

It is ***Mr. Leung’s*** second key observation in his report that’s a bit more controversial. REITs report “adjusted funds from operations,” or AFFO, a kind of cash-flow measure that represents the amount available for payouts to investors. However, there’s a lack of consistency in how REITs treat one-time and non-cash items, ***Mr. Leung*** says, and he also believes REITs’ attempts to “normalize” their maintenance capital expenditures can understate their annual costs.

So, as the REITs have made choices in how to present AFFO, ***Mr. Leung*** has made his own choices to adjust the metric. The result is that in his eyes, Cominar REIT, Artis REIT, Canadian Apartment Properties REIT and Dream Global REIT currently have annualized distributions that are at or exceed 100

per cent of his estimate of fiscal 2016 AFFO. He describes these REITs payouts as “the least sustainable.”

As you might imagine, a number of these REITs take issue with this analysis.

Cominar chief financial officer Gilles Hamel simply says his REIT believes there is “something wrong” in ***Veritas’s*** estimate “because according to our own forecast, our AFFO payout ratio for the year 2016 will be lower than 100 per cent.”

Artis CFO Jim Green says ***Mr. Leung*** has made a number of changes to what most REITs and the analysts who follow the industry consider to be the usual calculation of AFFO. Of particular impact, Mr. Green says, is ***Mr. Leung’s*** decision to use actual capital expenditures and leasing costs in the periods he looked at, rather than the normalized costs. “We understand his rationale, however this is not how AFFO and related payout ratios are usually calculated.”

Specifically, Mr. Green says, Artis had higher annual leasing costs in the past 12 months due to the renewal of a couple of large tenants and the difficult market conditions in Alberta. A reserve for capital expenditures or leasing expenses “is supposed to normalize these costs over time.”

Dream Global REIT’s distributions actually have exceeded its own calculation of AFFO in recent quarters. Tamara Lawson, the REIT’s CFO, says Dream Global’s distribution is sustainable, however, because the acquisition of top office buildings in Germany and Austria adds higher-quality properties to its portfolio. “Through our active asset management and leasing capabilities we expect to improve the respective net operating income, improving both the quality and stability of our cash flow going forward.”

Tom Schwartz, CEO of Canadian Apartment Properties REIT, says none of the other analysts who follow the industry “have any concerns about the sustainability of our distribution.” He takes a higher-level view of the capex issue, as he says his REIT’s business model has been buying apartment buildings in need of an upgrade, making those improvements, and raising the rent.

“If I buy a building for $10-million, and my engineers tell me it needs $2-million worth of capex, I present that to my board as a $12-million investment … If I have a building next door that I can buy for $8-million, and it needs $4-million of capex, my investment equation is identical. That’s a $12-million investment, but I’ve doubled my capex budget … everybody gets misled by the quantum of the capex budget.”

It’s certainly harder stuff to work through than the simpler question of whether a REIT depends on shoppers, renters or corporate customers to succeed. Ultimately, though, these things may have a greater impact on just how much each REIT can ultimately put into investors’ pockets.