Edward Jones
MAKING SENSE OF INVESTING

Canadian Real Estate Investment Trust (REIT) Industry Analysis

FINANCIAL SERVICES SECTOR REPORT

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ANALYST(S)

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Companies mentioned in this report followed by Edward Jones:

- **American Tower** (AMT - Buy; $248.03)
- **Digital Realty** (DLR- Hold; $153.56)
- **Duke Realty** (DRE - Hold; $38.56)
- **Equinix** (EQIX - Buy; $789.80)
- **Equity Residential** (EQR - Buy; $56.78)
- **Prologis** (PLD - Buy; $101.50)
- **Public Storage** (PSA - Buy; $213.40)
- **Realty Income** (O - Buy; $62.45)
- **RioCan REIT** (REI.UN.TO - Buy; C$15.03)
- **Simon Property Group** (SPG - Hold; $67.20)
- **Ventas** (VTR - Hold; $41.87)
- **Welltower** (WELL - Hold; $58.13)

Source: Reuters. Prices and opinions ratings are as of market close 9/1/20 and subject to change.

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Investment Overview

At Edward Jones, we view real estate as a good way to help improve portfolio diversification while providing relatively steady income streams for investors. For long-term-oriented individual investors, in particular, real estate investment trusts (REITs) are a good way to add that real estate exposure, in our view. In this report, we provide a REIT investment overview and our outlook for a variety of property types. Notably, we think the coronavirus has elevated the risks for retail, leisure, health care and office properties, while accelerating growth opportunities for industrial warehouse, data-centre, and wireless-communications tower properties.

Investing in REITs can provide several advantages:

- **Asset Class Diversification**. Many clients hold a balanced portfolio of U.S. stocks and bonds. Real estate is one of several other asset types, including commodities, high-yield bonds, and international stocks and bonds, that Edward Jones believes can diversity a portfolio. Diversification can potentially reduce volatility and enhance long-term investment returns.

- **Small Investment Size**. Direct commercial real estate investments, such as a motel or apartment building, can require a sizable one-time investment. REITs, which trade like stocks, can be purchased in almost any dollar amount.

- **Industry Diversification**. The purchase of REITs across several subindustries (building types) can also provide better diversification than buying individual properties.

- **Liquidity.** Most Canadian REITs trade on public stock exchanges, offering good liquidity. As of December 2019, there are 43 REITs listed on the Toronto Stock Exchange, with 19 included in the S&P/TSX Composite Index.

- **Regular Income**. REITs in Canada generally offer attractive yields, and most pay regular monthly dividends.

- **Regulatory Oversight.** Canadian REITs are subject to close regulatory oversight, and all trusts must be publicly registered with the appropriate provincial authorities.

When investing in REITs, we recommend that investors first consider the type of real estate the REIT owns, as different types of real estate have different risks and demand drivers.

History

The development of the modern REIT began in the U.S. with legislation passed in 1960. REITs were intended as a way for the average, individual investor to gain exposure to opportunities in commercial (nonresidential) real estate. The REIT model slowly evolved over the next two decades, becoming much more popular in the 1980s. In Canada, the foundation for the REIT market was laid by The Income Tax Act of 1986. It wasn't until the early 1990s when the REIT market began to develop, with the first REIT trading on the Toronto Stock Exchange in 1993.

In Canada, REITs are classified as mutual fund trusts and trade as units rather than common shares. The Income Tax Act provides for favourable tax treatment for qualified REITs. Generally, REITs must have most of their investments in real estate and distribute at least 100% of taxable income to unit holders. We note that REIT distributions, or dividends, may be taxable as income to individual investors. The tax rules are complicated, and we recommend that any Canadian investor in REITs consult a tax advisor.

Compared with the U.S. REIT market, which got an earlier start, the Canadian REIT market is relatively undeveloped. As a result, REITs are not major players in most Canadian commercial real estate markets, which tend to be dominated by large institutional investors such as insurance companies and pension funds. Most Canadian REITs are fairly small, and about 20 are currently in the S&P/TSX Composite Index.

Canadian vs. U.S. REITs

Over time, rules for Canadian REITs have evolved to closely resemble those of U.S. REITs. However, there are important differences:

- U.S. REITs are corporations while Canadian REITs are mutual fund trusts.
- U.S. REITs are required to pay out 90% of taxable income as shareholder distributions vs. a 100% rule for Canadian REITs.
- Canadian REITs tend to use more debt to finance operations, including mortgages secured by property holdings.
- Typically, Canadian REITs pay monthly distributions (dividends) as opposed to quarterly payouts for U.S. REITs.
- Finally, U.S. REITs have not adopted international accounting standards, which may present challenges when comparing REITs in the two countries.

Analyzing Canadian REITs

When analyzing individual REITs, we look for companies that can add value through the day-to-day operations of the properties. For instance, we look for shopping centre REITs with strong retail tenant relationships. Location is always important for real estate, and Canada's major metropolitan areas probably offer the best demographic trends for REIT properties. In addition, the scarcity of available land in big cities can provide a barrier to new competition.

Canadian REITs are subject to International Financial Reporting Standards (IFRS). Typically, REITs report funds from operations (FFO) in addition to traditional profit measures such as net income and earnings per share (EPS). FFO are essentially net income prior to noncash and nonrecurring items, such as depreciation expense and amortization, and gains and losses from property sales. In addition, FFO exclude any changes in the estimated market value ("fair value") of the trust's real estate investment portfolio. Most REIT investors and analysts use FFO as the primary earnings measure for REITs. In our opinion, FFO provide investors with a more accurate assessment of the recurring cash flows being generated by a REIT than EPS.

One thing that Canadian REITs have in common with their U.S. counterparts is a tendency to focus on specific types of properties. This can take advantage of the management team's specialized expertise. We believe the real estate classes described below will serve the long-term interests of REIT investors. They typically offer investors good current dividend yields, combined with the potential for growth in dividends over time.

Major REIT Property Types

(1) Apartments

Apartment REITs are probably the easiest type of REITs for individual investors to identify with, since most of us have paid rent to a landlord at some time in our lives. Over the long term, we expect apartment REITs to benefit from changing demographics, particularly the maturing of the baby boom echo (millennial) generation, which tend to rent longer and should positively impact apartment demand. In our opinion, the overbuilding of apartments in local markets is the biggest risk of investing in apartment REITs. We think high unemployment rates due to the health crisis are a risk that is currently being offset by steady white-collar employment and fiscal stimulus. We recommend large and geographically diversified apartment REITs to help reduce the risk of weakness in any particular market.

(2) Retail

Some retail property types, such as shopping centres, have historically been among the most stable due to their long-term leases. However, high-profile tenant bankruptcies and struggling department stores, combined with inroads by e-commerce, have resulted in retail REITs falling out of favour. Additionally, the coronavirus-driven lockdowns have led to increased pressure on already struggling retailers with weak balance sheets, and will likely accelerate bankruptcies. While the environment has grown more challenging for retailers, and, in conjunction, retail real estate owners, we believe high-quality retail REITs remain viable investments for long-term investors. We recommend REITs that are geographically diverse and have tenants across different industries (especially those resilient to e-commerce risks).

(3) Industrial Properties

Industrial REITs have historically tended to be fairly sensitive to the economy. However, with an accelerated shift towards e-commerce due to the virus, we believe demand will only increase for warehouse properties. When looking for REITs in this sector, we focus on companies that have strong financial positions and facilities in high-barrier-to-entry markets such as coastal cities. We believe the long-term tailwind of e-commerce will continue to drive strong pricing power for distribution facilities.

4) Self-Storage

The self-storage industry benefits from increased consumer spending and relocation. Self-storage properties tend to generate high operating margins relative to other real estate sectors because operating costs and real estate taxes are often lower. In addition, capital-expenditure requirements and maintenance costs for self-storage properties are modest versus other real estate sectors. In our view, the biggest risk with respect to self-storage is the entry of unsophisticated competitors, given the relatively modest cost to develop and maintain a self-storage facility. This risk is mitigated to a degree by local zoning and entitlement requirements that often make the development of self-storage difficult.

(5) Health Care

Health care REITs typically lease properties to health care providers under long-term contracts. For most health care real estate, demographic factors, rather than economic forces, tend to drive demand. Although an aging population is expected to drive demand for health care real estate over time, we believe there has been an oversupply in senior housing the past few years. Unfortunately, with elderly residents being particularly vulnerable to the coronavirus and lockdowns limiting visits to medical facilities, the health care REIT sector has been among the most exposed to the virus. We believe this headwind could last for a couple of years until effective treatments and a vaccine are developed.

6) Wireless Communication Towers

Infrastructure is a relatively new category of REIT, pioneered by companies operating wireless and broadcast communication sites leased mainly to cellphone-service providers. These companies have attracted significant investor interest due to the rapid growth of wireless communications, with the next leg of growth being driven by 5G (fifth generation). In addition, growth opportunities have emerged in many international markets. Revenues are relatively predictable due to long-term lease contracts. Compared with U.S.-focused REITs, wireless-communications REITs face more foreign currency and geopolitical risk. Any industry consolidation among cellphone-service providers could also present future challenges. We believe demand has been relatively unaffected by the virus.

7) Data Centres

Data centres are another infrastructure property type that we believe will be relatively less affected by COVID-19. In fact, with the accelerating digitalization of the economy, we think data centres stand to benefit over the long term. Demand for data centres will be driven by trends such as cloud computing, 5G, artificial intelligence, and working from home. We think data-centre REITs that have strong customer relationships with leading cloud- and communication-services firms will be able to attract many other tenants to their ecosystems.

Figure 1. REITs Followed by Edward Jones

Property Type	REIT Stocks and Ratings
Apartment	Equity Residential (EQR - Buy)
Cell Tower	American Tower (AMT - Buy)
Data Centre	Digital Realty Trust (DLR - Hold)
Data Centre	Equinix (EQIX - Buy)
Health Care	Ventas (VTR - Hold)
Health Care	Welltower Inc. (WELL - Hold)
Industrial	Duke Realty (DRE - Hold)
Industrial	Prologis (PLD- Buy)
Retail - Mall	Simon Property Group (SPG - Hold)
Retail - Single-Tenant	Realty Income (O - Buy)
Retail - Shopping Centre	RioCan (REI UN.T - Buy)
Self Storage	Public Storage (PSA - Buy)

Valuation

In our analysis of equity REITs, we employ several valuation techniques. These include the current price-to-funds-from-operations (FFO) ratio versus historical ranges, the REIT share price in relation to its estimated real estate value, the average common dividend yield compared with historical ranges, the current common dividend yield compared with U.S. Treasury bond yields, and indicated value via a dividend discount model.

Risks

We believe economic recessions present the biggest risk to investing in REITs. During a recession, rents and real estate occupancy levels generally fall, resulting in lower earnings and related property values. In addition, if interest rates rise rapidly, REIT share prices could decline. Other risks to investing in REITs include a considerable increase in the amount of new construction (which would reverse the favourable demand-supply characteristics of the current market) and the potential for large common stock issuances. We note that because of their high payout requirement, REITs generally need to raise capital in order to finance their growth plans. These capital raises can impact the common share price of the REIT.

Conclusion

The Canadian REIT market is small compared with its U.S. counterpart, but it still offers investment opportunities. REITs offer long-term-oriented individual investors an opportunity to enhance portfolio diversification while providing attractive yields. We think it makes sense to own REITs specializing in several property types. While Canadian REITs are exempt from corporate income tax, distributions may be taxable to the individual investor. We recommend consulting with a tax advisor before committing to an investment.

For more information, please see your financial advisor.

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