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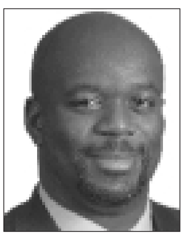
Investing in REITs — what you should look for

The free cash flow from Canadian REITs has remained relatively stable since 2007, despite the market volatility

By Dennis Mitchell


Dennis Mitchell

One of the benefits of this job is the heavy marketing load it entails — the opportunity to go out and meet your investors and find out what's going on in the real world. One of the detriments of this job is the heavy marketing load it entails — the obligation to go out and meet your investors and find out what they think of you!

On this recent trip, I've visited eight provinces and met over 500 of my current and future investors. And I can tell you three things most of them have in common. First, most are carrying more cash than they really want to. Second, most are looking for a low risk, income solution for their clients. Third, they're still anxious about the market, and the recent volatility has only made that worse.

Most investors, retail or institutional, measure risk as a function of price volatility. The flash crash on May 6 reinforced the riskiness of the market for them. But in reality, very little happened to the intrinsic value of most companies. All that May 6 proved is that the interconnected systems, electronic and human, that comprise the market are flawed. I called my wife after the market closed that day and asked her if she noticed that the world had almost come to an end. She hadn't. But then she's a nurse — she works for a living.

At Sentry Investments, we look at risk as the potential for permanent loss of capital. When valuing companies, we look at their ability to generate free cash flow, and so, we measure risk as a function of the volatility, duration and quality of that free cash flow stream.

This is far from revolutionary and I will readily admit to a stunning lack of originality or creativity in my investment process (hey, even Buffett copied Graham). But it should be obvious that, if an investment generates highly volatile cash flow from assets with little residual value, then that investment is rather poor, regardless of how volatile its trading price is.

Nevertheless, a lot of those commercial mortgage-backed securities issued in 2004 through 2008 contained pools of 100 per cent loan-to-value second mortgages in Nevada, California, Arizona and Florida to unemployed "homeowners." The ability to create an AAA-rated tranche out of these basic elements is truly one of the great marvels of modern finance.

The *starting* point of our valuation process is an exercise in quantifying the riskiness of a potential investment. The duration of the cash flow stream is a function of the duration of the lease term. Generally, longer is better since it results in greater visibility of future cash flows.

The quality of the cash flow depends on the tenants and/or covenants providing the rents. Generally, national, multinational, government — investment-grade — tenants are preferred. Finally, the volatility of the cash flow stream is mainly a function of the occupancy level of the REIT through a full business/economic cycle. Putting it all together, we look for REITs that have long-term, low volatility, high quality cash flow, as measured by long-term leases to credit tenants with stable, consistent occupancy.

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Now in the recent past, REIT unit prices have fluctuated dramatically, despite the transparency and contractual nature of the revenue stream. But the free cash flow from Canadian REITs has remained relatively stable since 2007, despite the market volatility.

Looking at the 11 REITs in the S&P/TSX Capped REIT Index, they generated a combined $1.45 billion in funds from operations (FFO) in 2009 — up 3.2 per cent from 2008 levels and up 5.4 per cent from 2007 levels. FFO is a key measure of earnings from a REIT, and the growth of aggregate FFO during these time periods highlights the silliness of the sell-off in 2008 and justifies the rally in REIT unit prices in 2009.

From a stability standpoint, very few REITs can match **Calloway REIT** (CWT.UN-TSX, $20.98). From fourth-quarter 2009 through first-quarter 2010, Calloway's occupancy went from 99.3 per cent to 99.0 per cent, troughing at 98.4 per cent in Q1/09. Throw in the fact that 26 per cent of Calloway's revenue comes from Wal-Mart Canada and you get a rock-solid cash flow stream.

However, not to be outdone are a couple of multi-residential names. Generally, the last financial obligation people stop paying (at least in Canada anyways) is their mortgage or their rent. As a result, multi-residential REITs tend to have very stable cash flow streams. From Q4/07 through Q1/10 both **Boardwalk REIT** (BEI.UN-TSX, $40.81) and **Killam Properties** (KMP-TSX, $8.66) *increased* their occupancy. Boardwalk to 96.9 per cent from 95.3 per cent and Killam to 98.5 per cent from 97.3 per cent.

From a quality standpoint, very few REITs can match the quality of the tenants that **H&R REIT** (HR.UN-TSX, $17.06) boasts. H&R's top-10 tenants at Q1/10 provide 48.0 per cent of its revenue and are as follows: Bell Canada, TransCanada, Telus, Bell Mobility, Rona, Versacold Logistics, Canadian Tire, Royal Bank, Lowes and Nestle. When H&R finishes the Bow Tower in Calgary, Encana and Cenovus will be added to this list.

First Capital Realty (FCR-TSX, $13.98) is another company with a tremendous tenant roster. Sobey's Shoppers' Drug Mart, Loblaws, Metro, Zellers, Canadian Tire, TD Canada Trust, Royal Bank, Canada Safeway and Staples combine to provide 34.3 per cent of First Capital Realty's revenue. The next five tenants (Wal-Mart, CIBC, LCBO, Bank of Nova Scotia and London Drugs) drive this to 39.3 per cent of revenue. Both companies provide extremely high quality cash flow to unitholders and shareholders, respectively.

Finally, from a duration standpoint, no one comes close to H&R. With an average lease term remaining of 10.5 years, H&R is often compared to a corporate bond. However, H&R has several advantages over a typical corporate bond. First, the annual cash flow from H&R REIT (rents and cash flows) has positive slope whereas a bond generally delivers fixed and static coupons.

However, as an equity, there is always the potential for distribution cuts as well, and H&R's distributions were cut in half at the end of 2008. With that behind them and financing of the Bow Tower secured, H&R has recently announced a rising quarterly distribution schedule into 2012 that will restore much of the original distribution over time. Second, HR provides cash flow from a diversified pool of blue chip North American companies, whereas investors would have to invest in a bond fund to get similar diversification.

Finally, a number of clients on my recent marketing swing asked about tenants walking away from their leases, much the same way U.S. homeowners are walking away from mortgages. Unless a specific clause (i.e. co-tenancy, performance, regulatory, etc.) has been negotiated into the lease, the tenant is contractually obligated to make its lease payments for the term of the lease. Unless the company goes bankrupt, the rent is due. One is reminded of the Henry Hill soliloquy from *Goodfellas* with REITs playing the role of Paulie. Earnings down 30 per cent? Pay me. Dividend cut? Pay me.

Risk should be thought of as the potential for permanent loss of capital. While volatility can make investors nervous, lack of volatility is usually a greater indication of mounting risk. The complacency that extended periods of low volatility can imply, provides the killing field for risk to stalk your portfolio. Research your holdings, understand their cash flow streams, and above all, purchase these cash flow streams at prices that compensate you for all of the risks you are assuming.

Dennis Mitchell, CFA, is the lead manager of the Sentry Select REIT Fund, which has over $400 million in assets.