Canadian REITs poised to outperform U.S. peers Stronger economy, healthy banking sector underpin Canadian REITs
By Tania Haas

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TORONTO (MarketWatch) — Canadian real-estate investment trusts are positioned to outperform their U.S. peers thanks to Canada's strong economic fundamentals and the real estate sector's more solid outlook, analysts and investors said.

Higher employment, a healthier banking sector and a better financing environment mean Canada's real-estate investment trusts (REITs) are poised to extend their stronger historical performance while U.S. REITs struggle against the background of a lingering housing crisis and high household debt levels. But some analysts caution that the sector may have seen most of its gains for the current cycle.

"Compared to U.S. REITs, Canadian REITs offer investors higher yields and better historical total returns," said Dennis Mitchell, Chief Investment Officer and Senior Portfolio Manager at Sentry Investments, which has about C$7 billion in assets under management.

"The fundamentals of the Canadian commercial real estate market include higher occupancies, a better financing environment, higher consumer spending and lower unemployment," he said.
Canadian REITs have been helped by Canada's better economic situation, Mitchell and others in the industry said.
More jobs lead to higher housing occupancy rates and stronger consumer spending and Canada's unemployment rate of 7.3% stands out against jobless figures from other major economies. The U.S. unemployment rate is 8.2%, while the euro-zone's rate is 11.2%.

The better financing environment is supported by Canada's strong banking sector, which earlier this year Moody's rated at AA2, higher than international rivals. The World Economic Forum also ranked Canada's banking system as the most sound in the world, four years in a row.

Both the U.S. and Canada are suffering from sluggish growth, each registering 1.9% gross domestic product expansion in the first quarter. But the weak growth, as long as it doesn't lead to recession, can help REITs because it should allow central banks in both countries to keep interest rates low, which in turn makes borrowing costs more affordable.

These factors add up to a better outlook for REITs in Canada, even though their U.S. counterparts also offer decent returns, Mitchell said.

“The outlook for Canadian REITs is more positive than U.S. REITs right now. However, despite that fact, U.S. REITs have kept pace with Canadian REITs, possibly because they were cheaper to start with,” he said.

Top picks

Michael Smith, an analyst at Macquarie Capital Markets Canada, has three top picks: Allied Properties (CA:AP.UN) , First Capital Realty (CA:FCR) and Boardwalk REIT (CA:BEI.UN) .

Allied Properties specializes in restored office space primarily in downtown Toronto and Montreal. Smith has an outperform rating on the stock in part because of solid leasing activity. The company saw a 7.8% rental bump over expiring rates in the first quarter, which will lead to greater revenue. And young workers in Canada’s urban centers want to rent homes closer to their downtown workplaces. Allied’s current yield around 4.67% also makes it an attractive purchase.

Calgary-based Boardwalk manages over 225 residential properties in five provinces. Occupancy during the first quarter stood at 98%, which Smith says is “likely at or near the highest it will get.” Boardwalk’s dividend yield is around 3.1%.

Canadian REITs picks by Mitchell at Sentry Investments include Dundee REIT (CA:D.UN) and Mainstreet Equity (CA:MEQ) . Dundee REITs’ dividend yield is around 6.01%; Mainstreet doesn’t offer a dividend.

Other institutional investors like James West attribute the positive REIT environment in Canada less to job creation and consumer spending, and more to population growth.

“Canada Immigration announced last month that it would seek to expand Canada’s annual immigration from the current 225,000 per year to 400,000 per year, creating primary consumer demand for all sectors in Canada, especially real estate,” said West who guides institutional clients through his firm Midas Letter Portfolio Advisors.
His top pick is Vancouver-based Partners REIT (CA:PAR.UN) , which under CEO Adam Gant, has grown from $C60 million in 2006 to today’s valuation of C$1.2 billion. Earlier this year it announced a dividend yield of approximately 8.7%.

“Partners focuses on commercial developments with tenants like Shoppers Drug Mart and Canadian Tire, who sell everyday consumables, and discount stores like Wal-Mart, who are in high demand regardless of employment stats,” says West.

One area of concern for REIT investors is the potential for rising interest rates. But sector specialists say rising rates are not always bad.

“It depends on why interest rates are rising,” said Mitchell. “If interest rates are rising because inflation is rising, the unemployment rate is falling and economic growth is picking up, then that’s positive for REITs.

“However, if interest rates are going up because Greece has defaulted and risk premiums are rising then I would expect all equities, including REITs, would suffer,” he said.

Mitchell owns U.S. REITs Simon Property REIT (SPG) and Brookfield Office Properties (CA:BPO) , which has properties in Toronto and Calgary.
Simon and Brookfield’s dividend yields are roughly 2.7% and 3.5% respectively.
Not for everyone

Some investors shy away from concentrating too much on REITs. Cumberland Private Wealth Management, which focuses on clients with C$1 million or more, has only one Canadian REIT in its portfolio.
Cumberland owns Chartwell Senior Housing REIT (CA:CSH.UN) . Steve Hall, an investment analyst at Cumberland, said Chartwell Senior Housing now manages about 186 homes in Canada, making it the largest owner-operator of senior housing in the country.

Hall said there is reason to be wary of how REITs will perform in the coming months.

“Hard to know what’s in store for REITs,” he said. “They’ve performed really well so far this year, but it’s good to ask yourself, can it continue? As Wayne Gretzky said, ‘You want to go where the puck is going, not where the puck is.’ ”