REITs can offer solid foundation

FABRICE TAYLOR

Globe and Mail Update

March 15, 2008 at 6:00 AM EDT

Real estate has lost its curb appeal. Investment trusts are down about 25 per cent from their highs, yet real estate is performing well. Rents and cash flow are still rising, and occupancy rates are high. So why have the shares done so poorly?

Partly because they were richly valued last year, and partly because investors are worried about the economy, the credit crunch and equity markets. U.S. investors, who have been fairly big owners of Canadian real estate names, have been selling in a panic, with little or no regard for the important differences between the two markets.

Yet REITs, and real estate in general, remain an attractive long-term investment. They're relatively stable, generate cash and, if you buy carefully, your capital should appreciate. As the sector gets walloped, the brave will buy and reap rewards.

For some guidance on how to buy a REIT, we turned to Bob Dhillon, chief executive officer of Mainstreet Equity Corp. and whiz real estate investor. (Note that Mainstreet is not a REIT, so he won't be recommending his own company.) Mr. Dhillon offered five key points to watch for:

1. Net asset value is key

“That's the No. 1 question,” Mr. Dhillon says. NAV is the market value of a real estate company's equity. Real estate and modern accounting rules don't get along well because land on a balance sheet, while not depreciated, also doesn't get marked up in value. However, we all know that land does go up in value over time. And some buildings do too. So analysts and investors recalculate real estate balance sheets using market rates and values. This can include discount or capitalization rates, which can change rather quickly. But by and large, net asset values, however volatile, can give you a better “snapshot” idea of the value of a real estate portfolio.

The direction of a company's NAV is also important. A rising trend is clearly better than a falling one. The reason a discount to net asset value is so important in this environment, Mr. Dhillon says, is that eventually the discount will close.

It may happen quickly through a takeover, merger or going-private transaction. Or it may have to wait until investor sentiment improves. But eventually, the trading value will move toward the net asset value. Buying at a discount to NAV when the latter has stabilized is a good first step. For individual investors, it's not always easy to get at NAV as they are provided by brokerage analysts and, sometimes, by third party valuators hired by real estate companies.

2. Safety of the distribution

Investors buy REITs for income primarily, so they should make sure that the distribution they're counting on won't drop. It should in fact go up. The payout ratio is key. How much cash does a REIT distribute versus how much it can. You have to be careful here, Mr. Dhillon warns.

Watch the way the company defines distributable income. Some REITs effectively define it as cash flow, but a savvy investor won't accept that. Buildings require capital spending – upkeep. This money comes out of cash flow, so you should deduct it from cash flow to get a better idea of how much cash a company can distribute and what the real payout ratio is.

You'll find capital expenditures in the financial statements. Be careful: some of the expenditures can be for growth – to add a wing to a retirement home for example – and that shouldn't be deducted from free cash flow. Only the part that's maintenance. Trouble is, you might have to ask management to break it out.

Be careful here, too. Maintenance should approximate depreciation. If depreciation runs at 10 per cent of revenue, and maintenance spending is only 3 per cent of revenue, there's likely going to be trouble down the road. The company is probably classifying upkeep costs as growth investments or it's under-maintaining.

And of course, you should give companies that are raising equity or debt to pay distributions a wide berth. “You can't dip into your equity to pay distributions for long,” Mr. Dhillon warns.

3. REIT's capitalization

Does it have too much debt? If so, these tough times will hurt. On the other hand, a company with modest debt – substantially less than 75 per cent of market book value (that is, the book value adjusted to use market values) – will find opportunities.

“You can't beat this environment for finding deals,” Mr. Dhillon says. Companies with too much debt will not thrive.

4. Management

Trust is a huge factor in real estate because the numbers don't tell a company's story as well as they do in, say, manufacturing. Unfortunately, it's hard to trust anyone where money is concerned. So it's important that management has the same interests as shareholders.

Investigate related-party transactions carefully to see if they can lead your manager to put his interests ahead of yours. Mr. Dhillon says he wouldn't invest in a company unless the insiders own at least 20 per cent of the stock.

5. Geography

Some REITs deserve to trade at a discount to NAV because their NAVs are sliding down, Mr. Dhillon says. He's wary of Eastern Canada because of the high dollar, troubles in manufacturing and rising commodity prices. “Expenses are rising, so if your revenues aren't, your distribution is in trouble.”

He also points out that jurisdictions with some form of rent control (for residential REITs) may face problems in a world of fast-rising commodity costs. If rental increases are capped at a rate that's lower than cost inflation, bye-bye distribution.