REIT tingles spidey senses

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The spider sense starts tingling on page 3 of **Lanesborough REIT's** annual financial statement. That's where we learn that the trust is losing money – 22 cents a share last year, 23 cents the year before.

Bay Street likes to say REITs are all about cash flow, not profits. Whether or not you agree doesn't matter in this case, because turning to page 4 sends the spider sense to a higher pitch.

Lanesborough produced cash flow of $5.6-million in 2006, while it paid distributions of $9.6-million. The ratio of distributions to cash flow was about the same the year before and so far this year too.

As you've probably guessed by now, the trust, or more accurately the manager of the trust, Shelter Canadian Properties Ltd., made up for the gaping shortfall by raising $160-million in new debt and almost $40-million of new equity over the past two and a half years, mostly to make acquisitions but also partly to finance its distributions.

That's a dubious business model. But before we give you management's answer, a few more relevant points. First, to page 18 of the annual financial statements, and more specifically to related-party transactions, where we find a management agreement between the REIT and Shelter, which is controlled by Arni Thorsteinson.

This contract covers the day-to-day management of the trust's residential and commercial portfolio. The REIT pays a generous 4 per cent of gross residential receipts and 3 to 5 per cent commissions off commercial leases (half that for renewals). Shelter also gets fees worth 5 per cent of any renovation and improvement work. The REIT has paid more than $2-million in management fees under this deal over the past two and a half years. The payment this year will be more than 1 per cent of the trust's market capitalization, which is $92-million.

There's also the services agreement, which "provides the trust management and support services for the administration of the day-to-day activities." This payment is 0.3 per cent of the net book value of the trust less cash but plus, amazingly, accumulated depreciation. Shelter took in $503,857 from this contract in the first six months of 2007, more than twice as much as last year.

And finally we have the insider deals, whereby the REIT makes acquisitions from Mr. Thorsteinson's family trust (and no, he doesn't own much of the REIT – about 4 per cent according to Thomson).

Now let's turn to management for answers. On the subject of management fees, it points out that the REIT is small and that hiring its own management team, paying for head office rent and so on would be expensive. It's debatable that it would be more expensive than the agreements with Shelter, and you would also do away with potential conflicts.

Management also points out that other REITs charge similar fees. That's undeniable, and we would be remiss to suggest that Shelter is unique. That said, the REIT earns operating margins on residential of about 50 per cent. Mainstreet Equity, a corporate real estate company (that is, not a REIT), earns better margins even though half its properties are in the process of being renovated and/or repositioned. On its "stabilized" portfolio, Mainstreet earns 67 per cent margins. Mainstreet has no management contract.

As for the large gap between cash flow and distributions, Shelter says it will close it. How? The company's debt-to-market value ratio is only 57 per cent whereas management thinks 75 per cent is acceptable. In other words, it can refinance its debt and withdraw equity from its properties and deploy that money, much like U.S. consumers used their homes as bank machines for five years by having them reappraised and withdrawing every last cent of equity.

That might earn the REIT enough to close the gap if everything goes well. That's a big if. Even if management does execute extremely well, it has massive interest rate risk and commodity risk, given its predominantly western base (about half the residential business is in Fort McMurray).

REITs are popular, which means REIT sponsors can get away with this sort of thing (and again we stress that Lanesborough isn't alone. Shelter manages two other REITs with similar arrangements, and there are plenty more).

But investors would do well to remember what happened to those U.S. consumers mentioned earlier.